# ENTERPRISE
# IN A
# FREE SOCIETY


*BY CLARE E. GRIFFIN*

*FRED M. TAYLOR PROFESSOR OF BUSINESS ECONOMICS AT THE UNIVERSITY OF MICHIGAN*





1949

RICHARD D. IRWIN, INC., CHICAGO

First Printing, January 1949

PRINTED IN THE UNITED STATES OF AMERICA

TO

FLORENCE PARSONS GRIFFIN

# PREFACE

THIS book is written in the conviction that the volume of production, and hence the economic power and well-being of this nation, depends very largely upon the business enterprisers of the country. In a modern economy, there are several groups who must co-operate in the productive process. These include: the owners of resources; the workers at all levels; the suppliers of capital; the scientists, engineers, and inventors; and, finally, those who combine the services of all these and who activate production. These last are the enterprisers, or, in the language of formal economics, the entrepreneurs.

We here undertake to direct attention to these enterprisers and to the policies and attitudes of the government and of the general public which, especially in a democracy, are required to encourage them to perform their essential activating function. In an interdependent, and therefore a co-operating economy, all the "factors of production" contribute to a determination of the volume of output and of national income; the greater the supply of any of them, and of all of them in combination, the larger will be the volume of production, the higher will be the level of economic well-being, and the greater will be the economic power of the country. No one of them, therefore, can claim to be the sole productive factor. But because of the organizing and the energizing functions of enterprise, there is a special reason for emphasizing the practical importance of this factor, particularly in a dynamic and progressive economy.

The fiscal and other policies of government, the policies of special groups in the society, the attitudes of the public, and the general spirit of the people—all have a bearing upon the volume of production; but very largely they gain practical significance through the effects which they have upon the decisions of enter-

prisers. Business enterprisers, like other participants in production, are flesh-and-blood people, and their motivation is as complicated as is that of others. Like others, they respond to incentives; and in a free society these must be positive incentives that are attractive to them. In recent decades, owners, managers, psychologists, and others have given much attention to incentives for workers; and bonus plans, incentive payment schemes, and promotion policies have been devised and studied with a view to improving those incentives. But also in recent decades, we as a society have been much less concerned with the incentives of enterprisers. This neglect can obviously have serious consequences upon the future of an enterprise system.

We shall be concerned in Part I with the role of business enterprise in the expansion of production; in Part II with the policies and public attitudes that collectively would constitute a favorable climate for enterprise; and in Part III with a statement of the general philosophy which underlies the more specific proposals. This philosophy is that of traditional liberalism. It is advanced, not merely as a means of gaining economic ends, but as a framework of the good society in its broadest aspects.

The book has been prepared for the use of students in my course in the Economics of Enterprise, and in its development it has passed through several preliminary editions, issued for local use. It differs in several respects, however, from the usual textbook: it deliberately places the spotlight upon one of the "factors of production"; it deals with economics, but it concerns itself with social goals as well as economic institutions; and it has a thesis—some will say a bias. While I shall try to maintain a decent objectivity, I shall not attempt to conceal my preferences and convictions. These features mean, of course, that the book is not designed as an introduction to economics. If it should be found useful in college instruction, it should supplement, or, still better, follow, a thorough study of economic principles.

As is the case of anyone who has spent the best part of his lifetime in a field of study, my obligations are numerous and, in the case of writers and teachers, not readily recognized. Prominent among those who have influenced my thinking was Professor Fred M. Taylor, the honored teacher of many generations

of students at the University of Michigan, and a continual source of inspiration to his colleagues. Among more recent writers I am impelled to mention particularly the late Henry Simons, whose keen and uncompromising analysis of the requirements of a free society has served as a challenge to many popular heresies. Another group who must unfortunately remain unnamed are the many business executives in large and small concerns who have given their time and thought to assisting me to whatever understanding I have gained of the American business enterpriser. Special mention is due Mr. Paul G. Hoffman and the other officers and the staff members of the Committee for Economic Development, under whose auspices a preliminary study was made from which this book has developed. My obligations to colleagues in the Department of Economics and the School of Business Administration of the University of Michigan for counsel and for helpful criticism of the manuscript are too numerous to permit individual acknowledgment. For help of this kind, however, I owe a particular debt to the late Professor Fred E. Clark; and for assistance in the development of my course at the University of Michigan, to Professor Charles N. Davisson and Messrs. Julian Cumberland and George Elgass. My appreciation is also due, for loyal assistance in the preparation of the manuscript, to Miss May Inouye; and, finally, for unfailing encouragement in this task, as in all my other work, to my wife, to whom this book is dedicated.

CLARE E. GRIFFIN

UNIVERSITY OF MICHIGAN
January 1949

# TABLE OF CONTENTS

## PART I. ENTERPRISE AND ECONOMIC EXPANSION

## INDEX

# Part I

# ENTERPRISE AND ECONOMIC EXPANSION

# 1

## *THE CENTRAL PROBLEM OF A FREE SOCIETY*

THE United States and, indeed, all the countries of Western civilization are facing a problem which in degree, and to some extent in kind, is unprecedented in the history of the world. Upon the satisfactory solution of it depends the future of free societies. This central problem is that of reconciling the fact of economic interdependence with the aspiration for individual freedom.

### INTERDEPENDENCE AND FREEDOM

The people of these countries and of the United States in particular are more highly interdependent than ever before. This mutual dependence has greatly increased in the last one hundred and fifty years as a result of the progress of the Industrial Revolution, the growth of markets, and the domination of men's affairs by the requirements of the market and of modern methods of production. This growing dependence of one upon all has expanded in a number of directions. It has expanded geographically, as is shown by the obvious fact that the economic activities and fortunes of the people of one part of our country are importantly affected by the activities of others, and, likewise, that the economic facts and policies of other countries affect every individual in this country. The logic of the machine and of the market has thus brought into actuality at least one aspect of the dream of philosophers and religious teachers—the realization that no man can live to himself alone.

This mutual dependence is also shown in the relations of occupational and functional groups. The worker depends upon workers in other crafts and occupations, upon the suppliers of capital, upon the owners of resources, and upon business enter-

prisers; and all these depend for their success upon the workers and upon each other. In this country, for example, some four out of five people are employed; that is, they work for others. Nor does the other fifth escape this interdependence, for in so far as they are themselves employers, they depend upon employees and suppliers; and even if they are self-employed in farming or in personal services, they are dependent upon the market. By comparison with the conditions of a hundred years ago in this country, more people are dependent upon the market; and in degree, they are individually more heavily dependent upon it.

There is no need to dwell here upon the beneficent results of this interrelated economy. It is clear enough that many more people are alive today than could have been under any previous system of production; and it is clear that, on the whole, they are living much better. The fear of starvation, which in earlier centuries oppressed large numbers in even the advanced nations, has been almost abolished in those countries. A very large proportion of these people enjoy comforts which were previously available only to small privileged groups. And the fundamental security of persons and assurance of subsistence has been greatly extended. All of these are gains to be credited to the modern economy. But this complex economy has also imposed new hazards in the increased degree to which the efforts of individuals succeed or fail, depending upon the actions or inactions of others. Each has gained in significance for all.

Moreover, men live not merely by those material goods that are implied by "making a living." They can realize their ambitions only by freedom. This means not merely the civil rights of thought, speech, and religion, but economic freedom, that is, the freedom to engage in this activity or that, to work more or less, to work here or there, and to spend the fruits of one's work as one sees fit. Some degree of such freedom of choice is always essential to well-being. To have to accept goods that one wants less than other goods reduces satisfaction just as surely as would a general scarcity of all goods. As the minimum requirements of subsistence are met, this desire for self-determination increases; and, because of the gains already made, the ideal of free choice

has become not merely a dream for social philosophers but a practical goal for many people in these Western countries. The unique problem that faces our society is to reconcile interdependence and individual freedom. It is toward this problem that this study is directed.

It is evident that there can be no perfect solution. If a person were building a house under pioneer conditions, he would be independent and free; but his house would be a poor thing, and it would require very onerous and extended efforts. Today he will get an incomparably better house for less effort; but he will inevitably be less free in doing so because he is dependent upon others for materials, upon the demands of a dozen crafts, and upon local building restrictions. If he is to have the advantages of division of labor, he must, to some extent, accept the restrictions upon his freedom which such division implies.

However, the problem is exaggerated by the currently popular view that as a society becomes more complex it must, to be effective, be increasingly controlled in a conscious way by authority. This control seems to some to be obviously required in order that a person's efforts will serve others and that their efforts will serve him. But paradoxical as it may seem, it may well be that increasing specialization, division of labor, and extension of markets really require not more control but a high and increasing degree of freedom of individuals to seek their own ends in ways that may seem most profitable to them. Indeed, as we now look back upon the last two centuries, it appears that such freedom of action and of choice was an essential requirement for the creation of free markets and that they, in turn, were a prerequisite to the Industrial Revolution itself. If it is true that the Industrial Revolution depended in the first instance upon the breaking-down of controls, it may well be that its extension today requires even more of that freedom. Thus, as society becomes more complex and interdependent, it may be that we need more of that flexibility which is provided by the spontaneous aspirations and decisions of individuals, guided by the checks and balances of a free market, and also that the feasibility of centralized planning and direction of the affairs of individuals declines. If this be

true, as we shall argue that it is, it suggests an escape from the hard choice between abundance and security on the one side and freedom on the other. It suggests that the abundance and real security are to be best attained by an extension of freedom and that these ideals are to be gained together—not one at the expense of the other. It gives a basis of hope that this central problem can, with wisdom and good will, be solved.

## THE GOOD SOCIETY

When one embarks upon a discussion of enterprise in its several relations to a free society—as indeed upon any broad social question—fairness to the reader requires that he state as honestly as possible what his large objective is, that is, his conception of the end toward which we should strive. For even though he may not consciously be undertaking to offer a blueprint for a good society, his every judgment, his selection of subjects for discussion, and his emphasis on different aspects of those subjects will inevitably reflect his social values, his preconceptions, and, indeed, his prejudices.

These terms apply particularly to the ends that we have in mind, namely, those objectives that we regard as good and toward the attainment of which our inquiry is directed. The broad statement of the central problem of a free society just given does define our ends in general terms. But can we be more specific? What do people desire from this intricate productive system? The answer often given to that question is a "high standard of living," and that term does serve to suggest an abundance of desired goods and services which is evidently an objective of most people. On the other hand, the term as it is commonly used is vague. To some, it implies the amount of goods and services to which a people have become accustomed; and thus it is viewed as a concept of desired or customary consumption levels. But such levels, either as ideals or as actualities, are evidently quite different for different people within the society; and thus the term is subject to the weakness of all averages. It does not adequately suggest the attainment of desired goods by individuals or the great variety of desires which

those individuals have. Among the "things" which people evidently want are services as well as material goods, and especially do people want the freedom to choose less of these things and more of leisure. The truth is that there is no answer to the question "What do people want?" for they want different things or, to the extent that some want the same things, they want them in differing amounts and with differing degrees of intensity. Not only is this true of specific material goods, but it is also true of general objectives. Some will rate high the goods of the present; others will prefer goods in the future; some prefer more goods, others more leisure; and as to opportunity, which is an aspect of freedom, some prefer more, and others will trade a substantial amount of it for more security. Any attempt to simplify the problem by resorting to the "will of the majority" is merely a crude device which, though necessary on some questions, actually tends to conceal the great variety of desires.

While this variety exists in any society in which people are still individuals, it is accentuated with every forward step in production and income. There have been times and places in the history of the world when the need for goods was so urgent that for practical purposes one could measure economic and social progress merely by the supply of certain standard goods available to the individuals in that society. But as we have advanced to a point where minimum needs are met, the concept of economic well-being must be broadened to include the satisfactions to be obtained from the nonproductive use of time and the satisfactions that inhere in freedom of action for its own sake.

If we adhere to that concept of a good society which is basic to Western civilization, that it is one that best advances the interests of its members; and if we remember that the members of that society want very different things and in different proportions, it follows that the good society will have only certain minimum and general objectives of its own. Its chief objective will be to create a situation in which the individuals will be able to select and to pursue *their own* objectives. This seems in-

escapable. But then we come back to the fact that the possibility of attaining the ends of material goods, more refined and varied services, and leisure depends upon the actions of others and upon the effective integration of those activities. Taking these facts and aspirations into account, we can then state our objective as follows: *to facilitate and to encourage the development of the inherent abilities and potentialities of individuals and to improve the interrelations of people so that they may, to an ever growing degree, realize the ends that to them individually seem important.* To the extent that we make progress on this road, men will become free, not merely in the minimum and important sense of being free from the arbitrary rule of man over man, but in the positive sense of realizing their own potentialities and attaining the life that they seek for themselves.

It is perhaps not necessary to add that this is not a vision of anarchy. Clearly the maximizing of the freedom of all individuals to seek their own ends requires that all of them shall be limited in such actions as would reduce the freedoms of others. The ideal is a net increase in freedom. It does not imply that the individuals will be insensitive to the rights and needs of others—quite the contrary. Generosity in such a society does not cease to be a virtue. Indeed, the conception that the sovereign power, the majority, shall preserve for the weak and defenseless the right to their own values and the right to seek them in their own way is the highest form of generosity. But these provisos are not intended to weaken the objective as stated. *A good society will be one in which as many people as possible will be as free as possible to seek as successfully as possible the ends that to them seem good.*

So much for the ideal of a free society. The relation of free enterprise to it is twofold: first, that the general freedom to seek one's ends in such ways as one chooses—as long as they do not infringe upon the freedom of others—includes the freedom to choose between starting and conducting a business or working for another; and, second, that free enterprises—conducted, as they must be with due regard to the wishes of consumers, workers, and investors, as expressed in the market—will advance the freedom of choice of all these others. That these freedoms can

never be perfectly attained is clear. The ideal of a free society and of free enterprise as a part of it is to be envisaged as a road, not as a destination that has been reached. On this road there is plenty of room for progress, for reform, for growth, and for adventure.

# 2

## THE EXPANDING ECONOMY

THE ideals stated in the previous chapter clearly imply the need for continual progress. The objectives stated there are perpetually dynamic, for they suggest progress toward a condition that can never be completely attained. The point to be emphasized in this chapter is consistent with that aim: it is that a successful economy (i.e., a society regarded in its economic aspects) must be an expanding economy. And that conclusion applies with special force to a modern democratic-capitalistic society.

To say that we need an expanding economy does not mean that this expansion must be steady—that there may be no temporary periods of contraction. A free society will always show those irregularities. What is meant is that the long-run trend (secular as opposed to cyclical movement) should be one of expansion. As a general statement, we can mean by expansion an increase in economic activity, leading to increasing output of desired goods. The more specific aspects of economic expansion, of which there are several, will appear as we proceed.

### NEED FOR AN EXPANDING ECONOMY

A general expansion of economic activities—production, marketing, and consumption of goods and services—is "needed" in the sense that we must have it if we are to realize our ambitions for improvement, and also that it is a necessary condition to maintain even such standards as we have already reached. We shall consider the different aspects of the question in this order.

*a) Increased Production to Meet Material Needs.*—In view of the rapid progress that has been made in recent years, there is a tendency to conclude that the problem of producing the goods required to satisfy the desire for improved material standards

of living has been substantially solved. That, however, is a gross exaggeration, as will be seen if we consider the average incomes in terms of real goods of the people of the United States and, even more, if we extend our view to the people of the world. In 1947, a very prosperous year, the per capita disposable income in the United States was $1,190. This level marked a gratifying improvement over previous years. In 1939, for example, the corresponding figure, when expressed in terms of comparable price levels (1947), was $838. The improvement came partly from the productive work of a larger part of our population. In terms of disposable income per worker and again in terms of 1947 dollars, the amounts were about $2,400 in 1939 and $3,000 in 1947.[1] Relative to anything that has been known in the past, this record is encouraging; but viewed as national averages, the record falls far short of providing the material basis for the abundant life. When we remember the deviations from this mean which are a necessary part of a free system, it becomes even more clear that these figures do not provide a ground for complacency. The average incomes per person and per worker for other countries and for the world at large cannot be stated for recent years; but in the late 1930's it was estimated that, for countries accounting for some 80 per cent of the world's population, the average income per worker was under $10 a week; and only in the United States and six other countries (containing altogether about 10 per cent of the world's population) was the average as high as $20.[2]

These and other readily observed facts should be an answer to much foolish talk about "poverty in the midst of plenty" and also to that other popular cliché that "our real problem is no longer one of production but one of distribution." The hard fact is that, in terms of our production of material goods and even in terms of our present capacity to produce material goods, the world is still a pretty mean place. To make it a better place for the realization of human aspirations requires, first of all,

---

[1] Computed from data in the *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, January, 1948), pp. 113 and 115.

[2] Cf. Colin Clark, *Conditions of Economic Progress* (London: Macmillan & Co., Ltd., 1940), p. 2.

that we find ways and utilize them for increasing the production of material goods.

That the material well-being of a nation depends upon the amount of its production may seem too obvious to require reiteration. This basic fact was expressed by Adam Smith in 1776 in his observation that the annual income of a country depends upon the annual production of that country. It seemed necessary to him to emphasize the point at that time; and unfortunately, it seems necessary to re-emphasize it now. For in those days the policy of government and the thinking of influential people was directed toward elaborate regulation of the prices and trade of a country with a view to gaining advantages over other countries and thereby increasing the national income. The acceptance of the "simple and natural system of freedom" which Adam Smith advocated required that such fallacious ideas regarding the relation between production and consumption be swept aside once and for all. But today confusion still persists in the United States and in other free enterprise economies regarding this fundamental relationship. Although few people would be willing to deny the simple proposition that economic well-being rests upon production, they do deny it by implication when they strive to improve our economic position by restricting production or by restricting the effectiveness of work or the amount of work.

The relation between production and consumption is much more evident, although not more real, in a simple economy where people produce goods for the direct satisfaction of their own wants than it is in our highly subdivided economy where people perform services for money, which is used to purchase the goods that will satisfy their wants.

When a pioneer moved into the Middle West only one hundred years ago, his problem was quite simple. If he produced potatoes, salt pork, and other staples, he and his family would live; and if he produced more of those things, they would surely live better than if he produced less. There would have been no need to preach the doctrine of the necessary relation of production and consumption to the pioneer. But today his descendants produce potatoes to be sold in a market; and they have made the

dangerous discovery that, if potato farmers generally produce fewer potatoes, they will receive a higher price for them and possibly, in total, more dollars with which to buy the goods they desire than if they produced more potatoes. Other descendants of these pioneers are working in automobile factories in which it appears that if they and their fellow workers restrict the rate of production they may be able to exact for themselves higher wages and steadier employment.

But surely it is as true for the whole society today as it was then that such restrictive policies are bound to reduce real income. There are two differences between the two situations: first, today the interests of individual groups do not so clearly add up to the interest of the whole society; and, second, mental effort is now required to understand the economic principles involved. The simple truth is now hidden behind several veils of prices, wages, and the sometimes intricate working of an elaborate economic system. The same truth is still there; but, while it was obvious then, it now requires a conscious effort to see it.

Moreover, greater mental effort is needed to see it in our society than in a communist society. There it seems obvious that the people are working for the people, and propaganda continually reiterates that point. Here the surface fact is that the workers work for their employers, and the superficial view is easily established that harder work will benefit only the boss. To recognize that in this respect the boss is only an intermediary between the people as producers and the people as consumers requires some insight into the working of a free market system. Those who are concerned for the future of this system must recognize this psychological weapon which a rival system possesses and the need for countering it by a general understanding of the basic relationship of production and consumption which exists in any kind of an economic society.

The essential economic problem of this country and the world, then, is to get increased production. It is not necessary here to analyze the economic and other forces which determine the distribution of the national income. There are many forces and factors, of course, which do influence it; and they are im-

portant, both in determining the proportions of the benefits which will be enjoyed by different individuals and groups and in establishing the incentives which will spur these different individuals and groups to play well their part in increasing the total amount of goods to be distributed. One generalization, however, can be made without resort to a detailed theory of distribution. It is that how well the *working people* of the United States can live depends upon how much the *working people* of the United States produce. This statement is substantially true because the goods, at least the peace-time goods, produced by the workers of the United States must very largely be sold to the workers of the United States; and, therefore, a general increase in production must result in an increased abundance of goods and services for the workers of this country.

This statement is not so trite as it may appear to be, for it could not be made of all countries at all times. For example, it was not true under a system of slavery that how well the slaves could live depended upon how much the slaves produced. The slaves were not producing goods to be sold to themselves, and increased productivity would merely have the effect of increasing the value of the slave to his owner.

Even under a system of free exchange the statement would not necessarily be true. Under the old regime in France—let us say during the reign of Louis XIV—it was not true that the workers of France were producing goods to be sold to the workers of France. To a very large extent they were working to produce goods for the wealthy and privileged classes, either of France or of other countries. This is shown by the kind of goods, such as laces, silks, and fine wines, to which their work was directed. The products which were traded in such an important market place as Amsterdam included most prominently spices, laces, tapestries, jewels, glass, clocks, iron for munitions, paints and coloring materials for the artists, cloth of gold, furniture and mirrors, armor, and breviaries. These were obviously not goods for the consumption of the peasants and masses. By contrast, the goods of the great market places today are characteristically cotton, wool, sugar, wheat, meats and meat products, rubber for automobile tires, and tobacco—prod-

ucts that must be sold to the masses directly or after processing.

The introduction of mass production, the increased amount of capital employed in production, the consequent decline in the marginal significance of capital, and the corresponding rise in the marginal significance of labor have brought about the radical change from that economy to our own. It is true that some of American industry is devoted to the production of private yachts, laces, expensive jewelry, and so on; but the great mass of products of our leading industries, such as food products, clothing, and even radios and automobiles, have to be sold to the workers of the United States. Modern capitalism, therefore, has made our proposition of the substantial equivalence of workers' production and workers' consumption almost literally true, and that for the first time in the history of the world.

Indications of this general proposition are to be found in the data on national income in the United States. For example, we can say that from 1900 to 1938 between 85 and 90 per cent of privately produced income (excluding government payments) was in the form of wages and salaries or the incomes of professional persons, farmers, and proprietors.[3] These incomes were preponderantly returns for services, although some element of the incomes of farmers, professional persons, and proprietors should be attributed to the land and equipment which they were using. But this allowance would be relatively small; and as a rough approximation, we can say that, year by year, from 1900 to 1938, not less than 85 per cent and not more than 90 per cent of the privately produced income of the country was paid to workers (if we use the term "workers" here in its broadest sense). This means that, of such income, only between 10 and 15 per cent was property income from dividends, interest, rents, and royalties.

Comparable figures are not readily available for later years, but the same general point is emphasized by the fact that in 1947 the total personal income in the United States (excluding "transfer payments," such as veterans benefits), if divided on the same basis as used above, shows about 88 per cent for services

[3] The Conference Board, *Studies in Enterprise and Social Progress* (New York, 1939), p. 85.

and 12 per cent for the property incomes, i.e., dividends, interests, rents, and royalties.[4]

The conclusion of all this is that never before has it been so true that the economic well-being of workers depends upon the productivity of those workers.

We have seen, then, that one of the basic needs of a good society is increased production. This need rests upon the fact that the material needs of the world, by even the most modest standards, have not yet been matched by the annual volume of production. Moreover, since new desires arise as old ones are satisfied, the problem promises to be a continuing one; and it establishes the need for a continually expanding production and continually increasing effectiveness which will enable us to combine an increased supply of material goods with increasing leisure.

What has been said is perhaps enough to indicate the need for an expanding production and a rising level of economic activity. But there are other reasons which would place this compulsion for expansion upon us even if we were willing to accept for the future the existing standards of living. The fact is, however, that that choice is not open to the people of the modern world. There are certain forces that require us to expand whether we wish to do so or not. One of these is modern science.

*b) Science and Technology.*—In the last two hundred years has come the great growth of science: the discovery and development of steam power and mechanical methods of utilizing it, electricity, the internal combustion engine, and the other advances that have changed the problem of production from one of

[4] Percentage distribution of personal incomes, exclusive of transfer payments, 1947 (estimate) from *Economic Report of the President*, pp. 110–11.

| | | |
|---|---|---|
| Wages, salaries, and other labor income | 67 | |
| Professional and business proprietor income | 12 | |
| Farm income | 10 | |
| Total | | 89 |
| Rent incomes of persons | 4 | |
| Dividends | 3 | |
| Personal interest income | 4 | |
| Total | | 11 |
| | | 100 |

utilizing human and animal power to one in which those sources of power have sunk to relative insignificance. At the beginning of this period, the methods of production and the knowledge of the universe were relatively little advanced over those of 1,000 or even 2,000 years before.

A characteristic of this advance in science has been its cumulative growth. Each short step has provided the basis for longer ones; and through the applications of scientific discoveries to fields which at the outset seem to be unrelated to them, the process has been widened as well as hastened. Moreover, in the comparatively recent past, the processes of scientific advance and invention have been systematized and improved to a point where progress is facilitated and more predictable. We have in comparatively recent years made the greatest of all possible discoveries: we have discovered how to make discoveries. The scientific processes of hypothesis, experiment, verification, and generalization—unknown, or at least unused, in centuries past—are much greater in their potentialities than any of the concrete discoveries that have resulted from them and which command such widespread admiration. The import of these facts is that science is itself an expanding force and is characterized by acceleration. When one element in a situation is as dynamic as this one, it imposes a necessity of change and advance upon the whole system. In short, when the new techniques of production, transportation, and communication have been developed, it is impossible for the other parts of the economy, such as capital and labor, to remain unaffected.

But the question has been raised whether we would not do well to be satisfied with the existing supply of material goods and to take the gains in efficiency and mastery over the material world in the form of more leisure. For example, why should we not say, as a matter of public and social policy, that we will be content with the material standard of living which we have attained; and, if content, we will be able to produce the necessary goods in shorter work days and work weeks and possibly even with less strenuous efforts while we are working. This is not a feasible choice; for if people should decide at any time that they would be satisfied with the goods which could be produced

within an average 8-hour day, they could hardly maintain that decision in the presence of scientific advance.

Let us say that such people are working 8 hours a day and that the typical output of each worker can be represented by 8 units of goods; but then come the scientists and technologists with substantial improvements. According to the decision which we have assumed, all of the gain would be taken in reduced hours so that people would typically work 6 hours a day and receive 8 units of goods. And then one could conceive going on to 4 working hours and 8 units of goods. But it seems clear that people would be dissatisfied with this new arrangement because there is a diminishing utility for leisure as well as for goods. Long before we had gotten to the ratio of 4 hours to 8 units, many people would undoubtedly choose the ratio 6 hours to 10 units. In other words, they would try to maintain a balance between the value of additional leisure and additional goods. And in so far as they chose the latter (and many surely would have done so) we are brought back again to the need for expanded output. It may be that the desire for leisure and the increasing possibilities of attaining it will mean that the expansion of economic activities and output will not proceed so rapidly as the potentialities placed in our hands by inventors and scientists; but proceed they surely will, unless the fundamental standards of valuation should change radically, and that does not appear likely.

A special reason for thinking that they will not change radically is that leisure itself creates a desire for goods. Leisure in advanced civilization does not merely consist in doing nothing; it implies sports, entertainment, and the opportunity to enjoy a vast number of material things and services. Increased leisure thus calls for more transportation facilities, such as motor roads, lodging facilities, automobiles, and thousands of other things. Thus, as we attain more leisure, we need more goods with which to utilize it.

c) *Savings.*—As potential and actual production increases, we can safely anticipate that savings will increase. They may possibly increase as a proportion of national income. Observing that well-to-do people save a larger proportion of their

income than do poor people, there are many who conclude, that as the general level of income rises people generally will save a larger proportion of it. This may be true, although it is by no means certain. We can say, however—and this is all we need for our present purpose—that increasing incomes will presumably lead to increased savings in absolute, if not in relative, terms.

These savings will be made by individuals partly to provide for their anticipated needs in old age during their productive years. Savings made for this purpose, it is true, are to some extent balanced in the whole economy by the dissaving of the old; that is, the young and middle-aged members of the community are saving, and those who have retired are spending their savings. It is conceivable on this score that the activities of one group could balance those of the other so that there would be no net savings. But in a growing population, savings for this purpose will be larger than the dissavings; and in this country the population is still growing, even though for the last seventy years it has been doing so at a declining rate. And for the world at large, as material standards rise, there can be little question that the population will continue to grow.

Another reason for saving by individuals is to provide for contingencies, the "rainy day." Whether this saving be done by the devices of insurance or otherwise, increased savings for this purpose are also likely to result in a net of savings over expenditures from those savings. And another reason for savings is the desire to accumulate from current earnings the necessary funds for relatively large expenditures (such as the purchase of houses, automobiles, foreign travel, and household equipment.)

But these savings by individuals represent a withholding of demand for current goods. If that were all of the story, it would result in the unemployment of those who produce those goods. That savings do not normally curb the demand for goods is explained by the fact that these funds do not merely lie idle but are utilized by enterprisers for the creation of capital goods. It is by this means that society increases its plant, equipment, and reserve of goods. But these socially good uses of funds have the effect, in the first place, of increasing production of capital

goods, which is one form of expansion; and, in the second place, of increasing total output. We can say, therefore, that, if the members of the society strive to save for their own personal purposes and if these efforts are not to result in the unemployment of resources, the personal savings must be matched by investment; and investment increases production. Here, then, is another reason why increased potentialities of production create a compelling pressure for expansion—if, indeed, we are not to have enforced unemployment and an actual decline in production. And it should be observed that unemployment of this kind is a very different thing from voluntary leisure. The latter may often be desired; the former, never.

*d*) *Growing Population.*—In the United States the normal annual growth of the labor force, people able and desirous of work, is about 600,000 a year. Jobs must be found for these people if we are not to have increasing unemployment. The growth of population also creates a need for increased supplies of goods which a larger population requires if its living standards are to be maintained. A growing population means there are more mouths to be fed; and hence in total, though not necessarily in per capita terms, there must be increased production. Also, there must be more capital goods; for while it is true that each additional person comes into the world with a mouth to be fed and hands with which to work, he does not bring additional capital goods with which to work or additional land and resources. The result of a growing population is, therefore, that one of the factors of production—labor—is increased. That in itself creates a need for more capital goods, for more intensive use of land and other natural resources, and for different combinations of the productive factors. All this means change and the need for expansion.

*e*) *Competition of Societies and Nations.*—The rate of progress of technology and the resulting increased productivity is not the same in all countries of the world. Consequently, the relative standards of consumption in different countries are in a constant state of change. Where this condition is combined, as it is for most of the world, with easy communication and the spread of knowledge of how other people live, it tends to stimulate the

demands of those who are lagging behind. The effect of the American movies upon the desire for the amount and type of goods common in this country illustrates this force. Moreover, in the rivalry of ideologies, an important factor is bound to be the extent to which the people of one country feel that they are materially as well off as the people living under another economic system. The need for an expanded production and a higher standard of living, therefore, attains political and ideological importance.

It is necessary, unfortunately, to add that the possibilities of war in these days cannot be safely disregarded. In view of the heavy demands which modern war makes upon the productive capacity of a country, this continuing hostile rivalry creates an obvious need for every modern country to expand its productive facilities. Moreover, this does not merely mean facilities for a narrow range of goods that can be classified as munitions of war, for nearly every industry falls directly or indirectly into that category. It has unfortunately become true, as Wendell Willkie expressed it, that in the present world only the productive can be strong, and only the strong can be free. These considerations mean not only that a high level of productivity is required in absolute terms but, even more, that a high level relative to that of other countries is necessary for security. In such a situation, no nation in the world can afford to rest on its oars.

*f) Individual's Sense of Improvement.*—We said at the outset that our test of a good society is to be found in the opportunities which it gives to individuals to seek and to attain the ends that seem desirable to them. This, it will be observed, does not set a certain tangible goal which, when reached, would mark the end of the road. We could look forward to such an end of the road if we had taken as our goal the attainment of a certain minimum standard of living or a certain average or national income. But the ends that to people seem desirable will continually advance as progress is made. This is to say not merely that new wants will arise as old ones are satisfied, which is true, but that either a sense of improvement or at least a sense of opportunity for improvement is one of the things most desired by

people. Indeed, it may well be that a sense of well-being depends not so much upon the absolute amount of material things as upon a sense of making progress or of having the opportunity for making progress. There have been times when a whole people or large classes of people have been afflicted by what might be called a "sense of claustrophobia." And when that sense becomes strong enough, revolt is likely to follow.

This sense of being hemmed in by social and economic forces is likely to be accentuated if there are obvious differences among the incomes and fortunes of the members of the society. It is conceivable that, if all people had to accept a mean and low standard of living, the situation might be accepted as a natural state of affairs; but when the example of more fortunate people is continually present, then a consciousness of improvement, or the feeling that with sufficient effort, intelligence, and good luck, the improvement may come, is needed for human satisfaction and hence for a good society. It is true that many, indeed most, societies of the past have maintained inequalities unleavened by any substantial hope of improvement in this world for the less fortunate. Such societies were bolstered by force, propaganda, and appeals to supernatural sanctions; and these devices for holding a society together are still prevalent. But they are not features of a free society with which we are concerned. This psychological effect of inequality among free people provides one of the dynamic forces leading to economic progress. This reason for saying that we need economic expansion is different from the first reason mentioned, namely, more production in order to live better than we do now. For this force means that we will *always* need higher standards of living, regardless of how high they may be at the moment.

We need expansion, then, for the psychological values that flow from a growing economy. The importance of these values for our inquiry will be apparent if we recall that the ideal which we have set for a good society is that in it individuals should have increasing opportunities to strive successfully for those ends that they as individuals deem important. Since one of the outstanding features of our society is a high degree of interdependence of its members, it follows that the opportunities

of individuals to seek their self-chosen ends will be enhanced if the economy as a whole is expanding, for in such a situation individuals will have a wider choice of activities in which they may engage. In practical terms, this means that workers will have the opportunity to work where they please; that farmers will have more freedom to produce what they please and more or less as they choose; that people generally will have more opportunity to choose whether to be self-employed or to work for others.

In these and many other respects, the individual in a highly active economic environment is more free than he would be if the other activities with which he must co-ordinate his efforts are at a low ebb. Likewise, the chances of his obtaining the material goods which he may desire from these efforts will be enhanced if the total volume of production is large. This is not to say that the individual is completely at the mercy of general economic forces. There have been inspiring and reassuring examples when, even during periods of depression, new businesses were started and were successful; and when workers did, by their own ingenuity and energy, seek out forms of employment which had been overlooked by others. And similarly in prosperous times some ventures will fail and some individuals will be frustrated. But quite clearly these do not serve to deny the general proposition that it is easier to grow in a growing economy than in a stagnant one—that it is easier to swim with the current than against it.

That it is easier to maintain freedom in an environment of abundance and growing abundance than it is in an opposite situation has been shown many times. The limitations which have disconcertingly been placed upon freedoms in England in recent years reflect clearly the condition of scarcity which has beset that country. And the limitations which some feel were placed upon individual enterprise and freedom in the decade 1930–40 in the United States could likewise be traced to a scarcity psychology. Conversely, the swing in sentiment of this country in the opposite direction during the forties again reflects the effect of high economic activity and growing abundance. Our interest in economic expansion is not in the goods for

their own sake or even in the utilities which they will yield directly, but it is in people; and what is desired for these individuals is that they shall have greater freedom and opportunities, as well as abundance.

All of these forces create a necessity for economic expansion. To a large extent, this applies to any country in the modern world; and it applies especially to one which aspires to maintain individual freedoms. These forces mean that the ideal of a stationary economy is not within the realm of possibilities for a free people. We do not have the choice of standing still. We must either advance or go backward. If we desire a degree of stability and equilibrium, it must be the equilibrium of the bicycle rider which is maintained only by his forward progress. We are like the characters in *Through the Looking Glass*, who found it necessary to run fast in order to stand still.

And there is no sign that this compulsion to economic progress is likely to come to an end, for it will be recalled that the reasons we offered for it are permanent ones, as far as we are able to see into the future. To recapitulate: the argument rests upon the growth of science and its corollaries of inventions and improved technology; upon the free choice of individuals to the direction of their efforts between the types of goods and the amount of goods and leisure which they will seek; upon inequalities of incomes which may equally arise from unequal money incomes, or inequalities arising from position or other reasons; in part upon a growing population and the need for supplying goods and employment to that population, and the change in the relative supplies of labor and the other productive factors created thereby; and, finally, upon the competition and rivalry of the nations for the advancement of their peculiar ideologies and for the maintenance of their position in the world. Of all these, the advance of science is probably the most potent. And barring the remote and long-time possibility of a genuine collapse of our civilization, science, now that it has gotten under way, is likely to move forward with irresistible force.

It should be noted, however, that the requirement for progress as the price of continued existence is particularly marked in a free-market capitalist system. A totalitarian state would not

face this necessity quite so clearly. It would be possible, for example, for such a state to refuse to utilize labor-saving devices and to regulate the amount of its savings. Indeed, this state presumably would make savings only in the sense that it diverted production from immediate consumable goods to capital goods. It would not, therefore, face the problem of inducing one group of individuals to make use of the savings of another group. Not only would it be true that such a thoroughly controlled economy could remain static, but it is believed by many that such a state could only be successful if it were relatively static. Certainly it would seem more simple for a collectivist state to operate an industry which had become stabilized than one in which continuous changes were necessary. A recognition of this fact seems to be implied in the policy of socialist states of first nationalizing banks, coal mines, and certain branches of transportation which are not characterized by rapid technological change. The point also is recognized by socialist theorists that industries and whole economies become "ripe" for socialism when they become stabilized. "Maturity" or "stabilization," in their view (and probably correctly) favors socialization.

A still further relation of the rate of progress and the question of collectivism is found in the fact that a totalitarian state would, in the opinion of many writers, inevitably become conservative. While we in the United States would regard a proposal to change to a collectivist state as a radical one, as indeed it would be, it is likely, nevertheless, that when such a state was once established, it would become more rigid and would tend to avoid the dynamic changes which characterize our system.

In several ways, then, it seems that private capitalism and economic growth are mutally dependent. Policies which, in the name of order or security or other ideals, would seriously check the dynamic features of our system would place in jeopardy the system itself.

## NEED FOR GROWTH OF INDIVIDUAL FIRMS

But even aside from these general social forces that require a net expansion of the economy, there are other forces that re-

quire the rise and expansion of individual firms even though such growth may be accompanied by the decline of other firms. Some of the specific forces applying to the individual firm, such as the effect of fixed cost, will be discussed later (Chapter IX); but here we note that such a force resides in the mere fact of change. Continual change comes from the shifting desire of people to buy such goods as they wish. It comes, too, from the discovery of new methods of production; from the depletion of some natural resources and the discovery of others; and from shifting populations and their rapid growth in certain geographical areas. The industries that are left stranded by such changes must be replaced by others if the community is to employ its resources to a desired extent. Or if we look at it in another way, the competition of new methods and of new things will force the retirement of producers using older methods and producing other things. This will be true quite aside from any, and even if there were no, net increase in production.

These shifts also take place between countries. Thus, every country, in order to meet the minimum requirements of its people, must be ready to expand some of its industries and to drop others as conditions change and where these changes mean a shift in the comparative advantages and disadvantages which countries have in the production and sale of goods. For example, England during the nineteenth century had a decided advantage over all other countries in producing many industrial goods; therefore, she was able to allow her agriculture to languish and to rely for her foodstuffs upon the export of manufactured goods. If, now, her comparative advantage in those lines should decline (even though her effectiveness in absolute terms may be maintained or even improved), it will be necessary for her to give up that whole scheme of things and produce foodstuffs more largely on her own island. Changes of that kind, whether they will be necessary in that particular instance or not, are characteristic of a changing world; for it is quite certain that scientific and technical progress and its application will not proceed at an even rate in all countries nor will the advantages of it be uniformly applicable to all countries.

Such considerations emphasize that change is the order of

things in this modern age. The possibility of maintenance of a status quo is as slight for individual businesses as it is for whole societies. A system which will be successful, therefore, must be one which is flexible and dynamic. We believe (to anticipate a later argument) that the greatest source of dynamic and initiating forces is in the free individual himself and, therefore, that a free society holds greater promise of being progressive and flexible than any other. But this point we do not ask the reader to accept at this stage. It will be examined further as we proceed.

## PROMISE OF AN EXPANDING ECONOMY

The necessity for a modern society, and particularly a free enterprise capitalistic society, to expand in order to survive has been noted by various writers. To some it constituted a threat to the continuation of this system. Among those who believed in this threat was Karl Marx, who, although he fully appreciated the contributions which capitalism had made to the material progress of the world, was convinced that the economic processes of that system would lead to its final downfall. There also have been nonsocialist writers who, especially during the 1930's, developed the thesis that the very facts of increased productivity and increased savings were leading our free society into a mature state and that in that state of maturity the society could not continue to function on the basis of individual direction of investment. There are still others who, while they disclaim any thoughts of purely economic factors bringing an end to our progress, believe that the very success of a democratic-capitalistic system would induce such political and social changes as would accomplish the same disastrous result.

Quite evidently our own view is in agreement with the foregoing to the extent of recognizing that progress is the price of survival, but there seems no necessary reason for assuming that that progress will not continue. That depends, we believe to a great and decisive extent, upon the maintenance of a social and political environment within which the normal forces that have impelled enterprise in the past can continue to function.

Moreover, while the need for expansion constitutes, in a

sense, a continual threat to the continuance of our system, it holds out at the same time the greatest promise that the world has ever known of raising income standards and freeing men from human tyranny and from the limitations imposed by scarcity of goods and of opportunities. Specifically, notice the effect of scientific discoveries and technological advance. On the one side, they show the way to reducing cost by means of conserving the use of labor. In the last analysis, cost reduction must show itself in reduced demand for the labor required to produce a given amount of a given thing. A well-known columnist has remarked that new inventions which would reduce costs should be favored if they did not throw men out of work. But the hard fact is that if new inventions do not displace men, at least in the first instance, then they will not be cost-reducing. The first effect is always to "throw men out of work." That should not be the final and net effect; but if the effect of unemployment is to be avoided, it is essential that the men thus displaced be employed in the production of more of the same thing or of other things. In a certain manufacturing plant an elaborate battery of machines is now doing the work which previously required the services of fourteen girls. The present machines automatically turn out these products with only the part-time attention of one girl. Fortunately, the company using these machines has been able to expand its activities so that the displaced employees and many more have been employed at the production of additional products.

But the other result of technological improvement is to make possible new and better things and services. The one aspect of technological progress then makes it possible for us to get old products with less effort (real cost); the other enables us to get things and services previously unknown. The second of these relates to our present question in that the production of new things provides an important employment outlet for labor and the other factors released by the cost-reducing discoveries. The progress of science and technology thus has these two opposing effects: suggesting ways by which business enterprisers can produce their goods with fewer workers and thereby reduce costs, and suggesting to them new and profitable uses of those

workers. If these two aspects are kept in balance and if businessmen are encouraged to employ both of them, no harm to the objective of full employment need result.

## ASPECTS OF ECONOMIC EXPANSION

In our discussion of the need for expansion and the vital role which it plays in a healthy modern economy, we have used the term "economic expansion" broadly and without precise definition. We should now inquire what is involved in economic expansion.

*a) Increased Production of Consumer Goods.*—The first and most important aspect of economic expansion is the increased production of consumer goods. The primary position of this phase of expansion arises from the basic fact that the end and purpose of the economic process is the satisfaction of wants through consumption; and production is the obvious prerequisite to this consumption. This fact should be kept in mind because from time to time other objectives, such as full employment, vie for this place of primacy. It should always be remembered that employment, like efficiency, gains its social importance because of, and only to, the extent that it contributes to production, just as production itself gains importance because it leads to satisfying consumption.

Now, how do we attain this increased production? The answer to this question will reveal the separate elements of which economic expansion consists. Production comes from the use of the productive factors: namely, land (including natural resources of all kinds); labor (including all forms of human energy applied to these resources); capital (including plant, equipment, and reserve stocks); and enterprise (the activity of initiating production by combining the other factors). It follows, then, as a general answer to our question, that an increased volume of production will flow from using *more* of the productive factors and using them more *effectively*.

*b) Increased Use of Productive Factors.*—The second aspect of expansion is the increased use of the supply of productive factors that is available at any time. Expansion in this aspect is popularly described as increased employment, and the task of

attaining it as the problem of full employment. This is a fair description if it be borne in mind that full employment refers not only to making jobs for workers but to using of all the other productive factors as well. Underutilization of plant, equipment, land, and managerial abilities are equally serious, from the point of view of the end result of a high level of production.

The economic system viewed as a whole always falls short of perfection in this respect. Even when the economy appears to be going at top speed, there will be some idle or partly used plant; some workers who are not employed because of immobility or because they are in process of transfer; and some land and resources lying idle. All units of all productive factors can never be fully used at one time; but even in boom times, better business administration and greater flexibility (mobility) can reduce this waste, and progress in that direction will increase production, while in periods of depression, this increased use of existing resources may become our most important problem.

*c) Increased Supply of Productive Factors.*—A third aspect of expansion is an increasing supply of the productive factors. What are the prospects of expanding in that way? Obviously, some are more subject to increase than others. At first thought, one might say that the land and natural resources constitute a fixed quantity, and in a sense that is true. But new lands can be opened up—at times by exploration, at other times by irrigation; and the supply of natural resources can also be affected by wise or foolish conservation policies. Other resources, such as new oil fields, are subject to discovery and exploitation. But even so, this particular productive factor is substantially fixed for a country at a particular time.

Likewise as to the second factor, labor, the supply might at first sight be regarded as fixed. But it, too, is subject to change, for example, by shifts in the customary work day; the changes as to the age at which people start work and the age at which they retire; the employment of women; and other ways. These are, to some extent, subject to a number of forces, some of which can be controlled. But again, limits would soon be reached in an effort to expand production through the expansion of the supply of labor.

The supply of capital, on the other hand, is a variable factor —at least in the long run. It is, in a sense, cumulative; for the capital accumulated in one decade or one generation, if prudent replacement policies are followed, provides a working stock for the next. And if a society be regarded in its long-lived aspect, it is the responsibility of one generation to pass on to the next a stock of productive equipment commensurate with what it had itself received and with its own potentialities. Specific capital goods are continually wearing out and must be replaced; and if the society is to progress, they must be augmented by new savings and the employment of those savings. In short, while we can think of a capital fund being passed on from decade to decade, we should not lose sight of the fact also that specific capital goods are continually being created and destroyed. A characteristic of the expanding economy is that there shall be a net addition. The importance of this factor from the point of view of social policy arises from the tremendous influence which it has upon the volume of production. It multiplies the effectiveness of human effort. It is worthy of special attention because the supply of capital is highly sensitive to the economic environment and particularly to the incentives to save and to make use of savings.

What are the possibilities of increasing the supply of enterprise? Enterprise is not such a concrete factor as the others. It is rather the function of employing the other factors for productive purposes. But while for this reason it is not so easy to visualize the supply of enterprise, it is clear that it will depend, in the first place, upon increasing the number of people and the groups of people who initiate activities of production in its broad sense and upon employing people and resources for carrying them to fruition. In the second place, it depends upon increasing the willingness and propensity of these enterprisers to perform their job. To increase this propensity to enterprise requires, among other things, an encouragement to take the chances that are involved in employing labor, capital, and resources. To increase the supply of enterprise, in short, involves getting more enterprisers and making existing enterprisers more enterprising.

*d) Effectiveness of Production.*—The fourth aspect of expansion

is the qualitative one of increased effectiveness of the use of these productive factors. This increased effectiveness involves, first, using the best known methods of production, that is, attaining the highest effectiveness possible in the existing "state of the art." A merit of a competitive system is that it places strong pressure upon enterprisers to come up to this standard. The penalty for ineffective use of productive factors is that the end product will not have a value as great as the factors which have been employed, and thus the inept enterpriser will lose money and thereby be eliminated as an enterpriser. Second, expansion through increased effectiveness involves the discovery of still better methods of employing the factors for making things. A certain degree of competition is necessary to bring about this result, although, as will be argued later in our discussion of innovation (Chapter 15), a certain element of monopoly or of quasi-monopoly also will be useful. The use of "better methods" involves a number of things. Among these are better forms of capital goods. Therefore, an important aspect of expansion is not merely the employment of more capital in dollar terms but the making of more effective capital goods. For example, a thousand dollars' worth of clumsy machines may be replaced by an equal value of more efficient machines. There are some economists who believe that economic progress has resulted even more from this improvement in the forms of capital than from the sheer increase in its amount. Certainly both have characterized the development of the American economy, and neither can be safely neglected.

Effectiveness is also increased by the better direction of labor and the elimination of waste effort. This is included in the recently popular and expressive phrase of management "know-how," which, together with a good supply of capital, is one of the distinctive resources of this country. And still another way of increasing effectiveness is to produce better things with which to satisfy active demands or to satisfy those unexpressed wants which may be developed into active demands. This sort of activity is, perhaps unintentionally, assigned an insignificant place by some writers, who describe the function of business as

producing things that people want and leave aside those things that people would want if they knew about them. These activities clearly increase the effectiveness, i.e., the fruitfulness, of our efforts. It is evident that these activities represent a phase of economic expansion if we remember that our objective is to enable individuals to increase their satisfactions. The world of today is better than that of previous generations, not merely or even mainly because we can secure the goods known at those earlier times with less effort, but because we have an abundance of goods today which were previously unknown—the telephone, the automobile, the radio, new kinds of food, and health-restoring materials such as penicillin and insulin. For the introduction and distribution of these new goods, sales promotion and selling activities, as well as the work of inventors and producers, are required.

The general phenomenon of economic expansion thus has four aspects—one which is dominant because it represents the major social end and three which are the means to that end. The dominant aspect is increased production; and the three subsidiary aspects are an increased employment of the productive factors, an increased supply of those factors, and the increased effectiveness with which they are employed.

The supply of the factors and the effectiveness of their use, while they should be distinguished, are actually closely related. Two examples will serve to emphasize this fact. First, an increased supply of any of the factors of production will facilitate an increase in the effectiveness of the others. Thus, with a given supply of land and labor, an increased supply of capital will have the effect of increasing the effectiveness of the land and labor. The effectiveness of workers is obviously increased when they are using a large supply of capital, as they do in the United States (more than $5,000 per worker). Likewise, with a large supply of capital, land and other resources are more effectively used, and enterprisers can be more effective. And so with each of the other factors of production. The relationship is especially notable in the influence which a large supply of enterprise has upon the effectiveness of all the other factors. But it is a general

principle that, when factors (land, labor, capital and enterprise) are used in conjunction, the effectiveness of any one of them depends very heavily upon the supply of the others.

The second example of the relationship between the supply of factors and the effectiveness with which they are used is that increased effectiveness makes possible an increased *supply* of the factors themselves. For example, a highly effective and hence productive society can increase the usable supply of land through irrigation. It can increase the supply of capital by facilitating savings and providing the opportunity to use these savings for productive purposes. Further, if industry is effectively organized, it may become possible to employ people who would otherwise be seasonally unemployed, thereby actually increasing the supply of labor.

## CONCRETE MANIFESTATIONS OF ECONOMIC EXPANSION

In overt and concrete terms, there are several manifestations of an expanding economy. One of these is a high birth rate of new enterprises; this is an evidence of expansion even if accompanied by a high failure rate, providing that the births exceed the deaths. There will normally be an expansion in capital resources, volume of business, and profits of existing enterprises. There will be a maintenance and expansion of capital plant, a discarding of old equipment and replacement of it by improved equipment, an increased sale of existing types of products, and the production and sale of new ones. New methods for performing old tasks will be devised. In the over-all scene, there will be an increased national income in terms of real goods and, consequently, increased real incomes of employees and of self-employed workers, investors, owners of resources, and enterprisers.

These and other features generally go together, and this fact suggests that economic expansion means simply the expansion of business activity. As a general statement, that is correct. But the different aspects of expansion do not necessarily proceed at the same rate, and there are times when expansion may be going forward on one front and not on others. An important illustration of this fact is shown in the changes in the supply of

capital goods from 1930 to the postwar period. In every decade for which records exist up to 1930, the supply of capital in the United States increased at a very rapid rate. During the period of the thirties, the supply of capital actually declined for the first time; and, in terms of the capital per worker, it is estimated that the decline continued to 1947. Here was a most radical change in national trends. It meant that we had a decline in the amount of capital even during the period 1938–47, when employment and output were both increasing. It was estimated in 1947 that to bring the capital per worker up to a level comparable to that of 1938 would require the formation and employment of about 53 billion dollars of capital.[5] It is possible that this fact was one of the reasons for the rather disappointing showing in man-hour productivity in the postwar period. This example shows, not only that the different aspects of expansion do not always go together, but also that there may still be need for expansion on some of the fronts even at a time when the country is working to its apparent full capacity.

It should also be observed that what constitutes expansion from the point of view of an individual business may or may not contribute to expansion for the whole economy. Generally, the displacement of one company by another in a competitive situation, does represent a net expansion, because it is to be presumed that the new company will utilize labor and other resources more effectively than did the old one. But when one company or one type of business is able to displace others by virtue of monopolistic power which it has artificially contrived or which has been granted to it by the government, as has sometimes been done, it is quite evident that this favorable conclusion cannot be drawn.

Moreover, expansion from the point of view of the individual business may consist of the mere shift of ownership of producing units. Company A buys company B, or a syndicate is formed to effect a merger of the two companies. In the few years preceding 1929, there were many such mergers. They created a great show

[5] Sumner S. Slichter, *CED Digest* (New York, Committee for Economic Development), November, 1947. See also comments on this point in Chapter 11 of this book.

of economic activity, and the prices of existing properties were bid up; but to a considerable extent, this was a financial phenomenon based upon the assumption by investors that a large company was worth more than the sum of its constituent parts. It is only fair to say that in some instances that assumption was true, but in many of them it was not. In these latter cases, the apparent expansion was spurious; and it is important to distinguish it from the real thing. For a wave of activity of that kind may merely cause a boom in the stock market and an unfounded optimistic business attitude which may have disastrous results. While we are not concerned at this point to argue against such manipulations of ownership and while we concede that they often serve good purposes, we do wish to emphasize that there is an important difference between the *contriving* of large concerns by such means and the *growth* of others by the normal processes of cost and price reductions, product improvements, and better marketing.

## THE VITAL ROLE OF ENTERPRISE

In one of its aspects enterprise is the regulator of the proportions of land, labor, and capital and the proportions of the subdivisions of these large classes, such as different kinds of laborers and different forms of capital. This aspect is the one which has attracted the most attention from economists in the past. For a progressive and expanding economy, however, this aspect is secondary in importance to that other part of the function of enterprise, namely, the initiating of *new kinds* of activities. It is strange that the emphasis of classical economists and others should have been so much upon the regulating aspect of the entrepreneurial function, for those men were writing in the nineteenth century and had before their eyes the example of the Industrial Revolution in its most dynamic phase and of a rate of change which was almost breath-taking. Surely these changes did not come about by themselves. Every new step in methods of manufacturing, transportation, and communication, and the thousands of new products that have appeared on the scene in the last hundred years have required that someone should *conceive* those new methods and products and that he

should then *act* to employ the passive factors of production to make the vision a reality.

The person who performs this initiating function is the enterpriser. The enterpriser may be an individual who is easy enough to identify—for instance, Henry Ford or the corner grocer. On the other hand, in large corporate concerns, it may not be so easy to identify the individuals who perform this function. (We shall have more to say on this question in a later chapter.) It is possible that workers may perform this function in order to provide employment for themselves, or that land owners may do so to find a use for their land, or that capitalists may do so to find use for their capital. But in these cases the workers, landlords, and capitalists are assuming a function foreign to their distinguishing nature. Although one individual may perform several roles, it is still important to distinguish between the roles. And as enterprise is distinguished from the other factors, there can be more or less of it just as there can be of the others.

One of the main theses of this book is that what a modern society needs most, if it is to be successful, is an adequate and increasing supply of enterprise. In this practical sense, it is the most important factor of production. In support of this view, three observations can be made. In the first place, no matter what the supply of the other factors is, nothing will happen until they are galvanized into action by enterprise. There are those, particularly the theoretical socialists, who claim a position of primacy for labor, asserting that all value is created by that factor. It is true that enterprisers could not produce anything without labor, any more than labor could produce anything without resources and capital with which to work or without management which would co-ordinate resources, capital, and labor. Certainly from the point of view of distribution of income, no one factor can claim all. The chief claim to the preeminence of enterprise is simply that it is the activating one. It is like the catalytic agent in chemistry; it is like the spark to the internal combustion engine. An adequate supply of the other factors will in no sense make up for a deficiency of this one.

But, in the second place, a supply of enterprisers can, to a considerable extent, make up for shortages of the others. If

there is a scarcity of labor, labor-saving machines can at least partially make up for that deficiency. If the supply of resources is low, new sources of energy and types of materials can be developed, as our rubber industry demonstrated during the war. If capital is not forthcoming from the traditional source of individual savings, the effective enterprise can produce more of it by the plowing-back process—the automobile industry was largely built in that way. Enterprise is thus the one factor that has the ability to produce or to develop the others or substitutes for them.

In the third place, it should be noted that the rise and decline of nations in the history of the world bear evidence of the greater importance of the intangible factors—imagination, initiative, and the will to act—than of the more tangible factors which many economists stress. If we look back over the history of the world to the nations which have been leaders in a political, military, or economic sense, we can recognize as outstanding among them Greece, Rome, Spain, the Low Countries (Netherlands and Belgium), England, and finally the United States. At different times in the last 2,500 years, these nations have been the centers of economic progress, power, and culture. But it is significant that, with the single exception of the United States, not one of these countries has been richly endowed with natural resources; no one would suspect from the tangible factors on which attention is often centered that they would have been leaders. On the other hand, there are countries, such as India, which have rich natural resources, a substantial supply of capital funds (in the form of gold, silver, and jewels), and a very adequate labor supply—all factors conducive to industrial development. The factor that seems to have been conspicuously lacking is enterprise. One group in India, the Parsis, constituting only about 100,000 persons, has demonstrated enterprising qualities and assumed the role of enterprisers; and in view of the small number of them, this group has made remarkable strides toward industrialization of the country.

We in the United States have been fortunate—partly because of the social institutions and religious concepts and ideals which the early settlers brought with them and for numerous

other reasons which it is now impossible to unravel—that we have been amply endowed with this creative spirit. We have been doubly blessed in that this intangible factor has been combined, for the first time at least in like degree, with rich natural resources. We have attained an enviable position in production, in high living standards, and in economic power as a result of this combination. There are two important truths for Americans in these days to remember: first, that an ample supply of resources, of intelligent and willing labor, and of capital would not suffice to prevent a decline in our position if this one essential factor, the spirit of enterprise, is allowed to wither; and second, that as this spirit is the least tangible of the productive factors, it is most subject to increase or decrease as a result of environmental influences of a social and political nature.

# 3

## *BUSINESS DECISIONS AND ECONOMIC EXPANSION*

Economic expansion, which we have argued is a necessary feature of a successful democratic-capitalistic society, comes about largely as a result of business decisions. While it can be favored by many broad economic forces of an impersonal nature, a general expansion is very largely, leaving aside mainly government-sponsored activities, the net result of the decisions of business enterprises. But these enterprises are made up of individuals; and, therefore, their decisions, which in total determine the scale of operations for the whole economy, are very personal matters in that they involve conscious and more or less deliberate choices by flesh-and-blood men. We turn, then, to a consideration of these business decisions, the sum of which determine the volume and nature of economic activity; and in a later chapter, we shall consider the motivation of the individuals who make them.

### NATURE OF BUSINESS DECISIONS

A decision is a free choice between alternatives, and it is made by a person or group who in fact has the authority to make such choice. This seems quite simple; and in the case of a single individual acting independently of others, there would be little need of pursuing the inquiry further. An individual, for example, makes a decision to establish his own business instead of remaining as a salaried employee; he conceives the idea, weighs the prospects, and decides upon his course of action. Having so started, he decides to add a new product to the line of goods to be manufactured or, if he is a merchant, to be sold. Here there is no problem of determining who the decision maker is and no practical need of determining what the process is.

But when, as is so often true in our modern economy, the business entity is a partnership or a corporation in which several individuals and levels of authority exist, we need to recognize that others than those who make the final choice play important parts in the process. There is the original conception of an idea that may well come from someone far removed from the authority level. Then the conception may be worked over and gradually take the form of a definite proposal. These steps are important because the authority decides between alternatives, and there can be no real decision unless there are such alternatives. Moreover, the decision will be made on the basis of the attractiveness of the alternatives, and that, in turn, depends on how they have been developed and presented.

Consequently, the character of an organization and especially its progressive or nonprogressive qualities may be greatly influenced by the kind of people who man its ranks and minor supervisory positions. An alert salesman, for example, may detect a weakness in some product or a gap in the line of goods. He or his supervisor may conceive a remedy for the problem in the form of a new product. Other imaginative men may improve upon it from the point of view of possible production. Others may determine probable costs and how the funds could be provided. At any stage, the project could be blocked by unimaginative or unco-operative employees; but if the whole organization is forward-looking and aggressive as well as hardheaded, it may proceed along the line until it finally comes to the seat of authority where it meets approval because the logic of the case is inescapable.

In such cases where the approval is given by an individual who possibly at the moment cannot think of a reason for saying "no," it may appear that the decision-making function has almost disappeared. Proceeding from this observation, the conclusion is suggested by some that the making of business decisions has been so subdivided and diffused that it proceeds in a virtually automatic fashion. The decisions of a business according to that view have, like so many other activities of business, become standardized; and even the most vital function of the entrepreneur, innovation, can be handled by a bureaucracy. It is

argued, therefore, that the need for individual enterprise in order to maintain progress and expansion has virtually disappeared. In short, the conclusion of this line of reasoning is that progress itself has been or can be standardized.

But a more valid view would seem to be that decision making includes the several steps of initiation, the weighing of alternatives and the final choice between them. The function is thus diffused in the large organization, but it is none the less personal and the incentives of all the people involved are still important. These incentives must be adequate to encourage individuals to take initiative and to assume the risks which are implied by sponsorship of a new project. Moreover, the process described by which an idea passes from one level to another is, in practice, an oversimplification. Ordinarily, the conception would come to the attention of a responsible member of top management before it had been so thoroughly worked out. The authorization to proceed with further investigation and development of the idea would be one of the important decisions, and the vitality of an enterprise will depend to a considerable extent upon the attitude of the management at that crucial point. The kind of people, the attitudes which they take toward their work, and the incentives which they have to bring forth such new ideas, result directly and very largely from the selection of personnel and indirectly by top management and the environment created in the enterprise; this can either be favorable to the initiation of new ideas or can lead to a general disinclination to "stick one's neck out." These features of the typical American private enterprise, although they may not be merely the lengthened shadow of one man, do reflect the attitudes and policies of the leaders. The qualities of those leaders and their incentives become, therefore, essential factors in determining the spirit and character of an enterprise.

## WHO ARE THE DECISION MAKERS?

Regarding the propensity of a company to expand, we have seen that there are a number of individuals involved; but the most important decision makers are those who in actual fact exercise authority to commit funds and to direct the efforts of

the enterprise to a certain line of action. When they are described in this way, we are referring to what classical economists call the "entrepreneurs" or, what are called in our more recent and expressive terminology, the "enterprisers." Defining this important "factor of production" has always been troublesome; it is really impossible to define it with such a degree of precision as will enable us to identify precisely those individuals who perform it in modern economic society. This would be difficult enough with any kind of economic organization or in any form of business concern, for the entrepreneur in theory has always been a sort of disembodied spirit. He is pictured as one who does no work but who employs labor; one who owns no capital but who obtains it from others; one who owns no land or resources but who hires them. His function in its pure form has been pictured merely as co-ordinating labor, resources, and capital. In actual life, there is no such person; and a recognition of this fact has tended toward a neglect of the importance of the function, for one can hardly become greatly excited about the welfare and the encouragement of a disembodied spirit. But actually the common sense of people recognizes that Henry Ford did create the Ford Motor Company and that the thousands of successful business concerns of the country have typically been established and expanded by the efforts, imagination, and daring of some individual. In short, entrepreneurship is a highly personal and dynamic factor, a fact that is not adequately suggested by the terms "co-ordination of activities" and "allocation of factors of production." In the inception of businesses and in the conduct of individual enterprises, it is not too difficult to locate the enterpriser because the conception, initiation, and the approval are all centered in one dominating personality.

But the rise of the modern corporation creates a problem, for the functions of these men are now to some extent absorbed and diffused through the corporate entity. In the legal theory of the corporation the stockholders delegate certain responsibilities to the managers as hired men. In this view the sole responsibility of these managers is to serve the stockholders and, particularly, to conserve their capital and to make profits for them.

In fact, in the modern corporation, this seems to be an un-

realistic view. The powers and actual authority represented by top management are greater than this legal theory would indicate. For one thing, while the board of directors legally represents the stockholders, it may, to a considerable extent, consist of the managers. To this extent we have the peculiar situation that the managers are their own bosses. As to other members of the board, they are often elected upon the nomination of the management. They are frequently included on the board because they can provide special advisory services or because they represent certain civic or other interests outside the corporation as well as, consistently with the legal theory, important groups of owners. Thus, in practice, the board may become an advisory group to management. Moreover, the policies adopted by the board very commonly originate with the managers. And so the two aspects of decision making—initiation and approval—are closely associated.

The distinction between the actual authority and decision-making as it is actually practiced and the legal theory of the location of those functions is somewhat similar to the distinction in the political state between legal sovereignty and actual power. In the United States, for example, ultimate legal sovereignty rests with the people, particularly in their capacity for establishing and amending the organic law. But actually the exercise of authority and the determination of the state policy rests with elected representatives and, to a growing extent, with the appointees of these representatives, some of whom are protected by civil service rules from ready displacement. To an even greater extent in a modern corporation, especially corporations that have widely diffused ownership, a relatively small group of men (perhaps a dozen or so), who occupy the highest executive positions and who usually by virtue of these positions are members of the board of directors, represent in fact the locus of power; and it is their decisions that determine the policy of the organization. If one is to try to put his finger, therefore, upon the entrepreneurial function, it is to be placed here. As a practical matter, it is the decisions of such persons who preponderantly determine such matters as the direction and the rate of development of their concerns.

It is true that their power is by no means absolute. They can be checked by several groups. They can be checked by the consumers who must be satisfied that the product or service is worth the price and that it represents as good a bargain or a better bargain than is offered by any competitor. The consumers thus definitely hold a veto power on many decisions that the management might wish to make. Their actual power depends upon their abilities and willingness to do without the proffered goods and upon the alternative sources of supply provided by competitors. The workers are another group that must be satisfied. Wages and working conditions must be satisfactory, at least relative to alternative opportunities for employment. The bankers who lend current funds to the enterprise must be satisfied with the security and the concern's promptness in settling obligations. The bondholders, if any, have claims which must be met. Finally, the stockholders must be kept reasonably satisfied. Thus, there is an elaborate system of checks and balances which prevents the exercise of power in an arbitrary way.

But of these various groups, the view here expressed is that in many cases the stockholders are in no more strategic position than the others; and management does not have to take any different attitude toward them than it does toward the others. Just as the consumer must be given a product that will satisfy him and just as the workers must be given wages that satisfy them, so the stockholders must be given dividends sufficient to encourage them or others to provide the desired funds for carrying on the enterprise. Mr. Alex Dow, for many years head of the Detroit Edison Company, once described the responsibilities of top management as running in three directions: to the public, to the operating staff, and to the owners. This concept puts management in the key position, for he did not say that top management owed this responsibility to owners, who *in turn* were beholden to the others. Rather, the manager owed these responsibilities directly.[1] The statement, it is true, referred to

[1] The terms "responsibility," "duty," and "rights" are often used with a looseness which I would like to avoid. A responsibility or a duty implies a corresponding right; and, aside from those described as "moral" or "natural," a right implies some sanction by which it can be enforced. In a competitive society the consumer's "right" to a satisfactory product rests upon his freedom to give his patronage to another. The right thus does have

a public utility; and in other types of companies, the management may conceive that their responsibilities run to the owners but that those responsibilities cannot be fulfilled unless the interests of consumers and workers are also recognized. As long as these interests are to be evaluated and met by managers, the two views are much the same.

In many large organizations, therefore, we can say that the enterprisers constitute the managerial group who actually make the decisions to expand. On the other hand, with many small and medium-sized corporations and with some very large corporations, the owner or a small group of owners still dominate in fact as well as in theory. We cannot, therefore, generalize merely on the basis of the legal form of the business concern. One must look at the situation as it exists in particular concerns. In some of the cases, the motives for enterprise will apply more clearly to owners; and in other cases, to managers. Both motives are relevant to the general problem of encouraging enterprise, though in a particular instance, it may be the one or the other that is decisive.

The enterpriser, then, is the man who starts a new business with his own money or with his own and others' money;[2] or he is the individual or group who decides upon expansion—to build a new wing to the plant, to add a new product to the line, or to hire more workers to increase output. The others—technicians, workers, and frequently the suppliers of funds—may be willing to put their abilities or resources to work; but under our system they must wait for the enterprisers, as we have defined them, to take the initiative.

## OTHERS WHO INFLUENCE DECISIONS

Besides these persons in key positions with whom we are particularly concerned, there are a number of others who in-

a sanction, and it implies the corresponding duty or responsibility of the seller. To the extent that this sanction is not present, consumers are likely to demand the aid of the state. In short, the practical alternative to state control is competition.

[2] This view is flatly contradicted by some who identify enterprise solely with owners. For example, one study asserts "that in all cases the enterpriser is the owner of the concern. . . . . A sharp distinction must be made between the function performed by an enterpriser and the function performed by a mere 'manager' of a business." National Association of Manufacturers, *American Individual Enterprise System*, Vol. I, p. 448.

fluence decisions. In the first place, there is labor. There have been suggestions in recent years that labor should, to a greater extent, be taken into management councils. From the point of view of maintaining interest and morale, there may be merit to the suggestion. If, however, it is implied that labor should assume a degree of the responsibility and the variability of reward that is associated with the entreprenuerial function, it is very questionable whether that would be a good bargain for labor or even whether it would be acceptable to workers when that implication is recognized. We are, in this connection, principally concerned with the role of laborers as hired workers. There is needed, however, a degree of loyalty to the enterprise if it is to be successful and be able to expand. This prospective loyalty of workers to the enterprise or, on the other hand, to a larger group (a labor union) which cuts across the boundary of individual enterprises, may indeed be a factor affecting expansion. It may affect the expansion merely because of the effect of such attitudes upon costs, and it may also affect expansion through the influence which it has upon competition. If bargaining is conducted on an industry-wide basis, that fact may well have the effect of forcing employers into a corresponding employer group and thus of limiting healthy intercompany competition which is one of the mainsprings of business expansion. Evidences of a trend in that direction have appeared in certain industries in this country and even more so in some foreign countries. Moreover, the possibility of a labor monopoly using its power to raise wages would presumably have the same deterring effect upon expansion as would a monopolistic control of any other necessary factor of production—an essential raw material for example. The motives that will control individual laborers and labor groups or their leaders thus become factors in the decision of anyone who is considering the alternatives of working as a salaried employee, establishing an enterprise of his own, or making further commitments in a venture in which he is already engaged.

Another significant group in a growing, that is, a changing economy are the inventors, technicians, and the production men; for it is frequently the imagination of these men that provides

ideas for expanded production. In the same way, one cannot forget the marketing men who are engaged in selling and sales promotion. For the origin of ideas frequently comes from the possibilities which these men either see or develop for the sale of new products or the expanded sale of old ones. In both the production and distribution functions, the presence of men of originality and venturesome and aggressive characteristics will play their part; and the organization that aspires to be dynamic and expanding must be concerned with all these groups mentioned, as well as with the members of top management who give final approval.

And even outside the organization there are the bankers, suppliers, holders of patents, the officers of governmental agencies, and, in a sufficiently broad view, the whole body of consumers. The attitudes of all these people comprise an important aspect of the social and economic environment within which business functions. In short, it is probably not possible to have an expanding enterprise in a community where the people, as consumers and in their other capacities, are bound by tradition and excessive conservatism. Such dynamic qualities as American business has shown thus reflect the spirit, attitude, and motives of the whole population within which it functions.

## ORIGINATING AND EXPANDING A BUSINESS

From the point of view of providing and preserving the incentives for business, it is well to bear in mind that this expansion is sometimes represented by the establishment of new firms and sometimes by the expansion of existing ones. To adopt an analogy from biology, it results from birth and growth. In neither the biologic nor the economic case is it always possible to draw a sharp distinction when, in the one case, a new sprout comes from an established root or, in the other, when a new company is set up as a subsidiary of an existing one or as a successor to it. But there are many cases of individuals setting up their own businesses which, by any definition, represent genuine business births. In these the country should have a special interest for a number of good economic and social reasons.

What are the characteristics of these business starters? In the

first place, they are generally not young men who are just starting their economic life, but men who have had experience in the line in which they are about to engage. This experience has usually been gained first as an employee; although if we look at the number of firms established in a given year, in many cases the initiators are found to have been previous entrepreneurs in the same field. For example, one study indicates that, of 562 shoe manufacturers investigated, 43 per cent gave employment as their prior status; and 37 per cent indicated that this employment was in the same branch of the shoe trade. Another 30 per cent indicated their prior status as entrepreneurs (25 per cent in the same branch of the shoe trade). Only 19 per cent indicated that this was their first gainful occupation. (The remaining 8 per cent had been self-employed or unemployed.) In the case of shoe retailers, the percentage who had advanced from employee to employer status in this same trade was higher (54 per cent); and another 14 per cent had been entrepreneurs in this same line. For shoe retailers, 11 per cent gave this as their first gainful occupation; and for shoe wholesalers, the corresponding number was 5 per cent.[3] A recent unpublished study of 584 small businessmen indicated that nearly 85 per cent had gained experience or training directly applicable to the business before entering it. These and other observations point to the conclusion that new businesses are typically started by men who have some basis, by way of experience or direct observation, for judging costs and prospects of the venture which they are about to undertake.

Another question concerning these individuals is their wealth. The history of our industrial development has been characterized by the establishment of businesses by men of energy but small means; and in the notable cases, the outcome has been growth of the organization and wealth to the enterprisers. The observation is sometimes made that this method of establishing businesses belongs more to the past than to the present and future. Probably no conclusive answer can be given to this question. The case studies which the author has been

[3] Alfred R. Oxenfeldt, *New Firms and Free Enterprise* (Washington, D.C.: American Council on Public Affairs, 1943).

able to make lend no support to this conclusion regarding successful companies whose origins fall within the last thirty years. These observations are based chiefly on the medium-sized but successful companies, employing from 500 to 2,000 workers; and they seem to hold true also of the small businesses. Typically, these businesses were started by men who had gained some experience in the particular line or an allied one; who supplied a small amount of capital from their own savings; who enlisted some other funds largely on a personal basis; and who made good earnings, plowed them back, and thus prospered as the concern prospered. On this point there is danger of an optical illusion in that the companies one hears of *at the time of origin* are commonly those that start with considerable resources; whereas, when we look at the old firms, we usually find that they owed their start to very small beginnings. This apparent contrast leads to the erroneous conclusion that the successful existing companies started in a small way and that the new concerns of today are born large. From this a "trend" is deduced. The illusion arises from failing to see the large number of inconspicuous firms which are now being started, some of which may well be very notable in another decade or two.

There should be no special preference for having businesses started by poor men instead of rich men. Indeed, it would be socially and economically desirable if more men who had accumulated substantial funds would undertake the role of entrepreneur. In modern industry, however, there is a factor working against this in that men who have accumulated substance as employees and who have the desired experience for starting a business are often now employed as executives of existing large firms. The salaries, bonuses, prestige, and a number of the intangible advantages of entrepreneurship are already in the possession of these men, and that fact acts as a deterrent to their shifting from the position of employee to employer. For example, a successful vice-president of a large automobile company would surely think twice before he gave up the salary and perquisites of that position to become an independent entrepreneur. Such men are the very ones who would presumably be the most energetic and successful new enterprisers. If more of them are to

be led to this role, we should be as much concerned with providing incentives for enterprisers as we are with providing incentives for employees. There is considerable ground for the generalization that the present trend is toward making a safer and better world for employees (of all levels) and a less attractive world for employers. It is dangerous to make job making less attractive than job getting and job holding.

In the originating of a new business, who supplies the money? In the case of small businesses, the answer seems quite clear that the funds are usually and primarily supplied by the initiator or by his friends and relatives. From studies of this subject, it appears that these two sources of funds are the main ones in eight out of ten cases. Other sources include borrowing from banks, credit for supplies and equipment, borrowing on life insurance, and borrowing from loan or finance companies. At the present time the backing of a new enterpriser by the man of means on an impersonal investment basis appears to be infrequent. This is a matter of concern, for the combination of the active initiator who has the ideas and the energy and of the silent partner supplying a large part of the funds would seem to offer an excellent opportunity for the utilization of managerial and entrepreneurial abilities on the one side and of idle funds on the other. So while we can say, at present, that it does not seem to be a typical combination, we should bear in mind its potentialities; and in the formulation of public policies, particularly tax policies, we should give due attention to the possibility offered by it.

In the expanding of an existing business the functions of conception and initiation, on the one side, and the supplying of funds, on the other, again appear. In this case, particularly, the former group of functions seems to be especially worthy of emphasis because, in the case of an existing and successful concern, if there is a well-considered and strongly backed proposal for expansion, the funds can usually be obtained. This is, of course, not universally true; and there is no desire to lose sight of the importance of capital formation by the process of personal saving and the venturing of those savings.

With certain lines of activities, such as public utilities and

railroads, the decisions of individual stockholders to advance more capital of their own or of new investors to supply funds constitute the most important sources of capital for expansion. On this fact turn certain important questions of public policy. For example, if funds for expansion in these fields are to be provided in this way, then personal income taxes upon those in the higher income levels who could be expected to provide the funds may be a serious deterring factor. On the other hand, the regulations of government bodies, such as the Securities and Exchange Commission, can and allegedly have hampered such companies in the securing of funds.

But with most manufacturing and merchandising concerns, the characteristic way of providing funds is through the earnings of the company itself. The typical procedure seems to be that a concern starts with relatively small funds, frequently provided on a more or less personal basis. If it is successful, it withholds from distribution a part of its earnings and plows it back into the business. That is quite clearly the method of growth of small and medium-sized organizations today, and it has probably always been so. The undistributed profits question, to which so much attention has been given in recent years, is by no means a new phenomenon. It is the method by which most of the medium-sized concerns in this country have grown, and it also has been the method of most giant companies. The Ford Motor Company is a very striking example, having grown from some $26,000 of original cash investment to a $2 billion organization entirely out of its own earnings. Indeed, for the automobile industry as a whole, it is estimated that some 80 per cent of the capital has been supplied in that way.[4] The significance of this widespread practice is that in a very large, and probably the most rapidly growing, part of the American economy the possibility of expansion arises directly out of past earnings; and the decision to expand is made by men who are identified with and responsible for the future of the enterprise rather than by independent capitalists whose funds have come from other sources and who would presumably be motivated more

[4] Lawrence Seltzer, *Financial History of the Automobile Industry* (Boston and New York: Houghton Mifflin Co., 1928), p. 266.

exclusively by the effect of expansion upon their personal incomes.

In addition to those clear cases of business birth and the equally clear cases of growth of existing firms, there is the rather large group of instances that partake of the character of both of these. An automobile company may decide to expand into a quite different field (prefabricated housing, for example) and will set up a subsidiary company for that purpose. This kind of proliferation is a common and probably a growing phenomenon in American business both on the part of the industrial giants and smaller concerns. The reasons for it are many, including a desire for diversification as a means of stabilizing revenues and employment, both in a seasonal and cyclical sense, to make better use of an efficient (and expensive) management staff, and many others.[5] Sometimes this distinct activity is kept within the old corporate framework, and sometimes it calls forth a new legal entity. Then there are the cases where the old enterprise is closed, and its resources are used in a new one. This, like the previous case, may be a mere corporate reorganization; or it may represent a genuine case of a new concern arising from the ashes of the old. A still less direct descent is one in which a successful company passes out of existence by merger or sale; and the fortune resulting from its operations and perhaps the experience gained in the old company become the basis a few years later of an entirely new enterprise.

One conclusion from these different forms of business expansion is that to a very large extent business growth is an autonomous process in the sense that its growth depends upon the success of the firm. The successful individual business concern is ordinarily a growing organism. At any rate, to the extent that it does grow, it typically does so with funds produced by itself, with initiative provided by its own management, and with hopes and fears centering around the enterprise as an entity. Incentives for expansion must, in such cases, relate closely to the welfare of that unit, as distinguished from the welfare of the individual stockholders or other owners.

[5] Cf. D. M. Phelps, *Planning the Product* (Chicago: Richard D. Irwin, Inc., 1947), especially chap. iii.

A similar continuity of business as a process appears in only a diminished form in many of the instances of the starting of new firms, for even in those cases we have seen that the business starter has typically been trained in another concern. His stimulus for new ideas has often come from that employment, as have his personal savings which provide the nucleus for the new enterprise. All this suggests that a healthy growth of business depends upon profitable enterprises. In the expansion of enterprise we are not typically starting afresh. Effort to encourage economic expansion must, therefore, start with the welfare of existing concerns, even more than and as distinguished from the welfare of the individual stockholders.

## BUSINESS DECISIONS AND EXPECTATIONS

The decisions which in their net effect constitute expansion of individual firms and of the total economy vary considerably from those which are almost routine in nature to those which involve very conscious choice of alternatives. For illustration, and at the risk of being arbitrary, we can recognize five groups of them.

First, there is the decision to use cash or credit to increase the scale of current operations. In a marketing organization, this may mean a temporary increase in inventories, as occurs when a buyer for a certain department of a department store purchases more stock because he observes that current consumer purchases are increasing and his inventories are running low. A similar decision may be made by a manufacturer because of increased sales, for the increased volume of business calls for increased purchases of materials, the hiring of additional workers, or the employment of present workers for more hours. Such decisions most commonly result from an actual change in sales or demand. But even this form of expansion involves some estimate of the future. The decisions rest upon expectations as, for example, in the placing of orders by retailers in the spring for the fall trade or the placing of orders in the summer for the holiday season.

Then there are the decisions to replace obsolete or worn-out machinery. At first thought, it might appear that this type of

decision involves not expansion but merely the maintenance of the existing scale of operations. It is included, however, because such replacement of machinery is not in the usual case automatically forced by the complete disintegration of the old equipment. Industrial equipment is not like the deacon's one-horse shay. On the contrary, the alternative is usually before the user to get along with the old machine or to replace it promptly. In total, the decisions to swing to replacement or to make the old machine do have an important bearing upon the total volume of business. Moreover, the decision to replace frequently involves a decision to invest somewhat more than was originally represented by the old machine, either because prices of machinery have changed or because new and better equipment is now available.

The third type of decision, which is clearly of an expansionist nature, is to buy more equipment or more expensive equipment. Such decisions, like those in the first category, may be merely a response to an observed increase in demand. On the other hand, they may be prompted by a desire to reduce costs. In so far as this is the basis of the decisions, one might expect them to be made during periods of depression as well as during periods of prosperity. That is, one might expect this disregard of business conditions if businessmen were purely rational and exclusively motivated to maximize profits or to minimize losses. Another source of such decisions is a desire to improve the product, the service, or the effectiveness of distribution.

Another type of decision is to add a new product or products to an existing line of goods. Such a decision will ordinarily involve the purchase of new equipment and additional supplies and the employment of additional operatives, advertising men, and salesmen. There are, of course, variations in the degree of newness of the added product. It may be completely new to the market, as electric razors and radios were when they were introduced; or it may merely be new to that particular company. In the latter case, there is a possibility that the new product may only displace a competing brand; and indeed in the former case, the product may merely attract consumers' dollars away from competing products. The introduction of a new product,

however, ordinarily involves net investment of capital funds and immediate additional employment. The sum total of the effects induced by this type of decision is, at least immediately, a major determinant in the total volume of business activity and employment.

Finally, there are the decisions to establish a new business enterprise. These decisions are most important because they are clearly expansionist in their nature and most variable in number and magnitude.

Concerning these five types of decisions, certain observations can be made. In the first place, all the decisions involve, although in varying degree, a judgment of the future. In the first group of decisions, that future may be very short indeed. But even when a haberdasher orders more shirts because the supply is running low, his decision at least implies that he expects the demand to continue for a few days or weeks as it has in the past. In most of the cases, a longer view of the future is required; and the element of risk is correspondingly greater. The second observation is that in all of these decisions there may be a question of whether we have an additional investment or merely a replacement. This distinction is largely a matter of degree and is of little significance as far as required incentives are concerned. The question of replacing old inventory or old equipment, or of adding a product to replace another which has dropped out, or of establishing a new business by an enterpriser to take the place of another which he has closed out—in any of these cases, the incentives to replace are very much the same as the incentives to expand. The essential fact is that at certain points in the operation of a business, real alternatives are offered; and from the point of view of the effect upon the economy, the choice that is made between these alternatives makes all the difference between economic expansion and contraction.

Such an alternative presents itself in a limited way whenever an existing stock of goods is sold out and needs to be replaced. The alternatives are more real when a machine is partially worn out or partially obsolete; they are still more real when one is considering the purchase of additional equipment. And we

reach the highest state of freedom of choice in the establishment of a new enterprise. But in all of these cases, there is presented a more or less free choice to commit funds and future services to a project in the hope of future satisfactions and rewards. "The hour of decision," in other words, is continually recurring in one form or another; and the way, therefore, in which those vitally important decisions will swing is continually subject to the influence of an environment which is, as Lord Keynes has expressed it, "agreeable to the average businessman."

Lastly, it will be noted that this list of decisions has not included the purchase of existing firms or other decisions that lead merely to the reorganization of control. Such decisions are important from the point of view of the individual concern; and when one talks with businessmen about a program of expansion, they most frequently mention their plans to buy out or otherwise absorb an existing company. When such decisions result, as they often do, in an aggressive firm taking over a property that has been languishing, it may in fact result in expansion; but there is a possibility that the new control will have precisely the opposite effect, as is likely to be true when the purchase is made to eliminate bothersome competitors. In any event, it is clear that shifting of ownership, although it may mean expansion from a private point of view, has no significance in itself from the point of view of the scale of operation of the whole economy.

The relative importance of future prospects and of present facts upon businessmen's decisions is judged differently by various observers. There are those who hold that businessmen are mainly influenced—some say almost exclusively influenced—by the conditions existing at the time a decision is made. And there are others who emphasize the importance of the future prospect. The classification of decisions suggested above seems to indicate that for some types of decisions the first group may be substantially correct; for other types, however, such as the purchase of more equipment or the building of new plant, the long-time prospect is far more important; indeed, the conditions existing at the moment gain relevance only through the bearing

that they may have upon the probable future. It is true that, if the future were entirely unknown and unpredictable, it might not be unreasonable to suppose that the enterpriser would conclude that, since future conditions are as likely to deviate from the present in one direction as in the other, the sensible view is to assume that the present conditions will continue. I believe it is rare, however, that businessmen are so completely devoid of any basis for guessing the future that they are forced into this position.

The question of the relative importance of the existing scene and the future prospect came to have more than academic importance during the thirties; then there were those who felt that, if an adequate volume of consumer purchasing power could be supplied at a given time regardless of its origin, investment and employment would respond thereto. This view led to an emphasis upon the importance of an expanding consumer market rather than upon the prospects of profits. The two are related, of course; but an important difference appears when we consider not only the production of end products but also the expansion of capacity. The importance of the latter will be recognized when we recall that the depression of the thirties did not stem primarily from a decline in the demand for consumer goods; it was fundamentally a "heavy goods" depression in the sense that the production which was most depressed was that of those goods involved in the expansion of capacity (plant and machinery), and the effects upon the rest of the economy ramified from this sector of it. A program of recovery under these conditions would succeed or fail depending upon its effect on the making of positive decisions of the higher grades as classified above. It is precisely upon those decisions that the *future of demand* and the *future of profits* have a decisive bearing. This fact was recognized by writers during that period who held quite opposing views as to practical policy. Professor Alvin Hansen, for example, observed that former recoveries "have typically been carried forward on a wave of new investment which was not narrowly gauged by the current and immediate level of consumption purchases. Large, bold projects, looking far into the future, have typically been undertaken in the upswing

period."[6] It seems reasonable to add that not only have such long-time projects been undertaken in the upswing period but they are the necessary basis for such an upswing. Professor Howard Ellis comments that, although the demand for capital goods "does derive from the demand for consumer goods, the derivation need not be from contemporary consumption."[7] The author is entirely in accord with this latter view, for it is true that the attractiveness of making a commitment now which will extend into the distant future must depend in large part upon the prospect of consumer demand for the goods which will be produced over a long period as a result of the present commitment. That is merely to say that the function of capital goods, and the justification for investing in them, is to facilitate the production of consumption goods. But the function of long-lived capital goods is surely not merely to facilitate the production of *present* consumption goods. We say that the present decision is "largely" influenced by the prospect of future demand because, from the businessman's point of view, the demand in itself is only one consideration; and it gains relevance only as it has a bearing, as of course it does, upon the future of profits.

[6] Alvin H. Hansen, *Full Recovery or Stagnation?* (New York: W. W. Norton & Co., 1938), p. 279.

[7] Howard Ellis, "Monetary Policy and Investment," *American Economic Review*, Supplement, 1940, p. 28.

# 4

## MOTIVATION FOR DECISIONS

If we, in a free country, desire to encourage the expansion of economic activity, we must induce individuals to take the appropriate actions; and to do that, we must rely upon effective motivation. As a preliminary step in the discussion of motives for business expansion, it is desirable to suggest a view of the different elements of motivation.

### ELEMENTS OF MOTIVATION

In order to induce action, people must have ability to take the action and motivation to do so. If we assume that a person is free and able to take the desired action, how is he induced to take it? That is the problem of motivation.

A common-sense conclusion is that there must be a need or desire and a means of satisfying it. Those are the subjective and objective aspects of motivation. The need, existing within the person, is subjective. (The distinction between basic, inherited, or biological desires and acquired desires need not detain us.) On the other hand, the means or object that will satisfy the desire is objective, i.e., outside the person. The conjunction of need and the object or goal, i.e., of the subjective and objective aspects, constitutes motivation.

If there is only a single desire and one means of satisfying it, the resulting motivation will lead to such action as is within the ability of the person to take. In such simple cases there is no problem—for example, thirst, as the subjective element, and a glass of water, as the objective element, provide the motive to drink.

The practical problems in motivation arise when choices have to be made. In such choices there is the competition between basic desires themselves; between alternative means of satisfying a desire, which we can call "positive incentives";

and between a balancing of the alternatives against the costs of attaining them, which we can call "negative incentives." The choice may be one of two types: first, a choice between competing means of satisfying the desire; and second, a choice between the positive incentive and a negative incentive associated with it. The motivation for drinking the water may be thwarted by the competing attraction of a glass of wine or by the negative incentive of arduous work required to get the glass of water.

Thus, different approaches or a combination of approaches are possible to motivate men to use their abilities to do a desired thing. First, we may stimulate the desire, thus enhancing its position in the individual's scale of values; second, provide the incentive or means of satisfying the desire; third, reduce the appeal of the alternative means of satisfying the desire; fourth, reduce the costs or negative incentives attached to or accompanying the positive incentive; and fifth, provide negative incentives, such as punishments, for not performing the desired act.

If, for example, we consider the establishing of new enterprises and if we assume that men have the ability and the means of doing this, we can identify several elements. One of the desires may be for independence. Then the situation might be described in this way: the basic desire is personal independence, but there are competing desires, such as security. These represent the subjective side of motivation. The incentive, the objective side, might be the owning of one's establishment. The competing incentives might include the gaining of independence as a salaried top executive. The negative incentives might include the hard work and worry required to establish one's own business.

If we wished to encourage a man to start a new business, there would be, as a purely logical matter, several possible approaches. First, an effort might be made to enhance his desire for independence—by education, for example; second, to enhance the yield of the desired act in terms of this basic desire, that is, to insure that the establishment of an enterprise did yield the satisfactions of independence; third, to reduce the attractiveness of alternatives—of salaried positions, for example, for the sat-

isfying of the basic desire; fourth, to reduce the negative incentives associated with the desired act, such as the costs, inconveniences, and uncertainties attached to the establishment of an enterprise; and fifth, for logical completeness, we should add the imposition of penalties for not acting in the desired way.

As to the first of these logical steps (discovering and enhancing the basic desire), we should remember that there are a number of such desires from which we might proceed, such as the desire for power or for creation; and the effort to direct social policy to the encouragement of such a complicated act as establishing a new business would have to take several of these basic desires into account. A number of them which can serve as the mainsprings of action will be noticed in the succeeding chapter. The second possibility (enhancing the fruitfulness of the desired act in terms of satisfying the basic desires) is, broadly speaking, one of the most promising lines and one which will be consistent with the retention of freedom of choice. The third approach (reducing the attractiveness of alternatives) is for the most part not practical, partly because there are ordinarily too many competing attractions which, because of other socially desired ends, we would not want to impair. The fourth approach (reducing the negative incentives) holds much promise. This amounts to removing artificial barriers and discouragements to the pursuit of an end that is desired both by the community and by the individual. It is, therefore, more than any other, the appropriate way in a free society. The fifth approach (imposing negative incentives for not following a desired line of action) is the method of authority, force, and orders combined with punishment.

As a purely practical matter and quite aside from the moral issues involved, the positive methods are likely to be more effective, especially with mature and responsible individuals; for the effort to use force becomes, in practice, ever more complicated as the number of objectives multiply. Imagine the problem that a dictator must have in trying to force people to perform such a simple act as digging coal. He will need a large number of guards and overseers; and there is the continual temptation for workers to slow down whenever they can, to feign

sickness, and possibly to sabotage the machinery. One cannot say that it is impossible to get results, for, with the use of propaganda the motivation of individuals may be influenced, and with the use of police methods their resistance may be overcome. But merely from the point of view of effectiveness, it is clear that negative incentives are costly and precarious instruments and poor substitutes for the positive and natural motivation on the part of individuals. It is fundamentally more effective to induce men to choose to increase their output by relying upon their basic desires, by trying to enhance the satisfactions which their efforts may yield, and by removing obstacles to action.

These have been the characteristic methods of "social control" of Western civilization in modern times, and the economic accomplishments under them testify to the practical utility. Furthermore, the devices suggested offer an answer to the philosophical problem of combining freedom and control. Contradictory as freedom and control may seem to be, it is possible to reconcile them by relying upon basic desires, by providing incentives which will satisfy them, and by removing obstacles. When these three steps are taken, the individual preserves his freedom of choice and still follows socially useful lines of action. And what is even more important, we approach the goal which we set for ourselves in the first chapter, that of enabling individuals to seek and attain those ends which to them seem important. Along these lines interdependence of the members of the society may best be reconciled with freedom.

## LEVELS OF MOTIVATION

Motivation for business decisions may be viewed in different ways which indeed are not contradictory but which can better be regarded as representing different levels. The first, in the sense of being the most readily recognized, is that of motivation in terms of a conscious, rational calculation of cost and rewards —usually in monetary terms. Indeed, business activities are often popularly distinguished from others on the ground that they are exclusively motivated in this way. Economists have contributed to this view with their assumption of the economic man. Certainly the classical economists, who were

frequently very broad students of human nature, knew that this was not an adequate description of real men. Be it remembered that Adam Smith was himself a professor of moral philosophy. But in the development and refinement of economic theory and for practical purposes, it appeared necessary to simplify the motivation of individuals; and this was done by assuming a single driving force. Businessmen, too, have contributed to this view and in so doing have perhaps deluded themselves to some extent. It is regarded as a commendable "hardheaded" approach to be controlled solely by the profit motive. In the sense of the daily conduct of business, no great harm may result from this statement of the case. If one would ask the players on a football team, for example, "What are your objectives?" they would probably reply, "To make touchdowns." And one could not say this was an unreasonable answer. It is clear, however, that it does not answer the question of why the players play the game. The answer to that question would have to be in terms of prestige, the love of a contest, and similar desires and compulsions. In fact, if a player is to give an intelligent answer, he must know the level of motivation in which the questioner is interested. As far as the conscious and rational calculation is concerned, there is no harm in saying that business enterprisers are primarily controlled by the profit motive. This level of their motivation we shall designate as the "economic calculation."

There is, however, a second level at which motivation may be viewed. This level deals with incentives as they satisfy ultimate or basic desires. They are the general human desires which influence all of us in varying degrees. They include such common springs of action as the desire for power or influence, the creative desire or impulse, and others. The decision to enter a business and to take chances and spend efforts to expand it can arise from these basic desires just as do other courses of action. They have, of course, their negative aspects that include the desire to avoid discomfort or, as the nineteenth-century psychologists used to say, pain. Since these deal with satisfactions or pleasures on the one side and pain or disutility on the other, this balancing will be called the "hedonistic calculation."

There is still a third level at which motivation or at least the

springs of action may be regarded and that is in the general state of confidence that prevails in a society, or to borrow a term used by Lord Keynes, "spontaneous optimism." That pervasive confidence may have its basis in sheer animal spirits or in an innate urge to activity which is greater at some times than at others and greater among some people than others. This third level, although more vague and difficult to analyze, may very well be the most important of all from the point of view of determining the level or tempo of the activity of a community. It also is important because it is partly a social phenomenon and, like the other two levels of motivation, is more or less subject to influence and control.

Our discussion of business incentives will consider these three levels, from the first, which is most readily recognized, on to the third, which is least consciously recognized, even though this may be a reversal of the true order of importance.

## THE ECONOMIC CALCULATION

At the conscious, rational level, our economic system functions very largely as a result of the income motive. Not only is it true that the desire for income provides the stimulus for effort, but, together with the forces of competition, it also directs efforts into particular lines. In the broad sense of the term "income," this has probably always been true, for rational people will attempt to maximize their satisfactions relative to the disutilities involved in attaining them. That would be true even of a Robinson Crusoe or of individuals in a primitive nonexchange economy. But today the income motive takes the form of monetary income, and people are guided to a very large extent by the desire for income in terms of dollars.

There are some philosophers and critics of the modern view who feel that this is unfortunate. They point out that the efforts which people make to secure things are not closely associated with the things themselves and that this has the effect of making many of our efforts seem pointless and mere money-grubbing. No doubt there is some truth in this complaint. For one thing, it has its bearing upon respect for property. A farm boy, for example, who has built a fence with his own hands is not likely

to be unmindful of the need for taking care of it. To him it represents hours of hard work, a fact which is not so clearly suggested by things which have been bought in the marketplace. In short, the good things which we now have are several steps removed from the work which was necessary to secure them. This complaint which goes back to Ruskin and others of the last century is quite futile, however. It is true that "in the devil's booth are all things sold," but a deeper insight would suggest that good things (at least, by definition, economic things) are always sold in the sense that effort is required to attain them. The fact is that the growing reliance upon money incomes as a basis of human motivation in the economic sphere merely reflects our growing economic interdependence, and this interdependence and its corresponding division of labor is the basis of the abundance which is so much desired to make men really free. As someone has said, there are places in the world where men still hammer out nails by hand; but it is also true that the children of those men are poorly clothed and poorly fed. Viewed in this way, therefore, the money-grubbing so often attributed to Americans is no less worthy than any other way of working for the things which are desired.

In the early days of this country, many people worked for themselves almost completely and only to a small extent produced things to be sold or exchanged for other commodities; some people worked for others and received wages for their services; and a relatively few worked for themselves and produced goods to be sold for profits. Today the first group has practically disappeared, and nearly everyone is either working for wages or operating a business to produce things which they hope will be sold at a profit. Of these last two groups, the wage and salary earners are the most numerous. We are to a large and an increasing extent a nation of employers and hired men. These broad facts are obvious enough, but we do not always appreciate the extent to which they represent a new relationship—that of the enterpriser-employer who buys and sells in the market and of workers who work for money wages. Probably a larger proportion of the people in Western industrial countries are involved in that complex than ever before. In such an economy the

supply of business enterprise is of dominant importance, and the economic motivation for the enterprisers in the form of profits for owners and managers is most significant.

The motivation of these enterprisers must be related to the particular functions which they perform. The job of the business enterpriser has three aspects. In the first place, it is his function to conceive a product or a service which can be produced and sold. This conception is different from the job of inventing because it involves a judgment of the market desire for the product, the feasibility of producing it, and the relation between the value of the end product and the cost of producing it. It thus involves imagination and judgment. It will be affected on the one side by optimism and on the other by cold calculation of the probabilities of costs and prices. The second job of the enterpriser in a private economy is to employ the factors of production on a contractual basis and to sell the product on the uncertain basis which future markets will provide. As a result of this relationship between employing the factors and selling the product, the enterpriser assumes risk. In the third place, he administers the factors of production in such a way as to coordinate their activities effectively within the business enterprise. The three functions of the business enterpriser then are: conception, risk taking, and management.

The social significance of the three are apparent. Any successful and progressive society must have an adequate supply of imagination and initiative; it must have an adequate supply of people who are willing to assume certain costs for uncertain gains; and it must have an adequate supply of directors or coordinators. In short, it must have an adequate supply of enterprise. In our society we depend for that supply of enterprise upon those individuals who are willing and who prove themselves by the test of the market to be able to assume these functions.

The major economic reward for the performance of these functions is profits. The pressure upon businessmen and the inducement to prospective businessmen to perform these functions effectively is very direct, because their rewards, or profits, lie in that "something left over" after all of the production costs have been deducted from the value of the end product. The profit

motive is the desire on the part of businessmen to attain that excess of value over cost, that is, of value of the end product over the values used up in producing it.

But the profit motive is not simply a desire for maximizing profits. The profit prospect, which leads to action, is a complex of a number of specific desires and aims. One consideration that will determine action is the size of the profit that is envisaged as a possible reward. The larger that prospective profit, other things being equal, the more likely action is to be taken. But another consideration is the assurance or the degree of probability of obtaining the profit. Another is apparently the prospect of regularity or irregularity of profits secured from a prospective line of endeavor. A fourth consideration is the prospect of loss of the principal itself. This last is a different consideration from the uncertainty of profit, which merely involves the earning of more or less, and is a positive incentive; the prospect of loss of principal is always a negative incentive and a deterrent. The profit prospect presented in a proposal to enter into the retail grocery business, for example, involves all four of these aspects.

Which one is the most important we cannot say. Probably their relative importance differs from time to time. Since they all join to form the profit prospect, it seems reasonable to conclude that, if some of them are less favorable then, in order to induce action, the others must be more favorable. Or the larger the risks that are created by "artificial," that is, nonmarket factors, the greater must be the reward to induce action; or if the reward remains the same, then the risks of a normal business nature that enterprisers will be willing to undertake will be smaller. A high degree of uncertainty as to public policy, for example, would have that effect. The same can probably be said of prospective instability of the price level. Since that is added to the necessary uncertainties of business, it will have the effect of discouraging action at the same reward level or of requiring a higher reward to induce that action.

The effect of rapid changes in technology is difficult to evaluate. Inventions do force the scrapping of old equipment and plant, and they do frequently offer the prospect of higher re-

wards; but on the other hand, the *prospect* of rapid or uncertain progress in the typical technology of the industry acts as an additional element of uncertainty. This technological progress, therefore, which probably acts as a dynamic and expansionist factor also has the effect (from the point of view of the profit prospect) of increasing the uncertainty of the business environment.

To the extent that the assurance of profit is impaired, the regularity of profit is reduced, and the chance of loss of principal is enhanced, the greater must be the possible profit. In this sense, then, any factors which bring about unfavorable changes in these three features of the profit prospect will require, if we are to secure an adequate supply of enterprise, that society shall provide or permit the possibility of larger profits. Conversely, if we can reduce the chance of loss of principal or improve the other features of the profit prospect by social policies, it will be unnecessary to provide such large profits in order to bring forth the desired supply of enterprise. And so, while we cannot give definite answers to a question of relative importance of these factors, it is worthwhile to notice that the profit prospect has more dimensions than the one which is implied in the proposition that the aim of business is to maximize profits.

The interdependence of the different elements of the profit prospect (the assurance of profit, its regularity, the chance of loss, and the possible amount of profit) is illustrated by the profit rates in different industries. In a well-established public utility, for example, the assurance of some profit is high, the regularity of return is also high, and the chance of loss of principal is relatively low. Consequently, the rate of profit which it is necessary for the enterpriser or investor to foresee is relatively low. On the other hand, in a mining venture the assurance of securing a profit at all may be low, the regularity of profit yield may be low, and the chance of loss of principal may be great; hence, the possible profit in the event of success needs to be and generally is high.

The profit prospect always involves uncertainty and risk, and these are necessary features of business enterprise. If by cost-plus contracts and other devices a contractor eliminates risk,

then he has put himself in the position of merely selling his services of planning and directing; and he is no longer, in the full sense of the term, a business enterpriser. The basic uncertainty is in the relation of costs and values, which exists even when a time element is not present. There usually is a question of whether factors A, B, and C can be combined in such a way as to produce a thing of greater value than the sum of the costs of those factors even at a given moment of time.

But the greatest element of uncertainty arises from the passage of time and the corresponding possibility of changes in the relationship of cost and price. In any kind of economy and particularly in one that largely employs capitalistic methods, it is necessary that commitments be made in advance of consumption or production. Such commitments, therefore, must be made for the sake of later and uncertain rewards. In our society, these commitments are made by individuals who enjoy a high degree of freedom.

The person who is committing funds ordinarily enjoys a higher degree of free choice than the person who is selling services, because services are perishable and funds are not. Thus, the person who is selling his services may have a very real choice between alternative offers for them. But his choice to sell them or not to sell them at all is not so real; for if they are not sold today, they cannot be stored up for a later time. Funds *can* be stored up, that is, they can be maintained in liquid form; and often this choice of liquidity appears more attractive than any available investment. On the other hand, not every business decision can be made anew. We shall see later in commenting upon new businesses and old, that old businesses are often in the position where it is virtually necessary to invest more funds in order to save those previously committed. But at least in determining whether or not to start a business and, to a very considerable extent, in determining whether or not to expand its activities, this freedom of choice does exist; and generally speaking, it is more pronounced than that of the seller of services or of most commodities.

In view of the relatively free choice between alternatives and the fact that these alternatives can be conceived in terms of

"more or less," even if the quantities visualized cannot be accurately forecast, the decisions of enterprisers are perhaps more a matter of conscious calculation than are most human decisions. It is well that this should be so; those decisions in the mass and in a free market economy largely determine to what extent our resources shall be used, for what purposes, in what combinations, and how effectively they shall be employed—in short, how effectively and wisely the people of the country will work to produce the things that those people want. The conscious weighing and balancing of alternatives, which to the individual enterpriser is the means of seeking profits and to society the means by which its most important decisions relating to the material basis of life are made, we call the "economic calculation."

# 5

## *NON-ECONOMIC MOTIVATION*

WHILE the profit motive in its various aspects goes far to explain the daily action and conduct of business, we must look beyond that motive if we desire an explanation of business enterprise. It is necessary to do this for two reasons; first, because in the conduct of business, the profit motive is not the sole driving force but is tempered and influenced by other considerations (very few human activities are completely dominated by a single motive); and, second, because profits are not an end in themselves but are means of attaining certain ends which people regard as important.

We turn then to these other underlying, if not basic, desires. In so doing, perhaps we should be guided by the simple generalization that businessmen are men first and businessmen second. In other words, they presumably have the same complex of ends which sometimes supplement and support one another, but which are more often in competition with one another. People generally, for example, desire a certain amount of security. But on the other hand, they desire a degree of independence; and these two are often in conflict. Most people, too, have an impulse to create. They have a desire to be well regarded by their fellows. Many of them have a desire to act in such a way as will contribute to the general welfare, as they individually interpret that concept. In our Western civilization, since nearly everyone is caught up in the economic system in some way and economic activities necessarily account for a considerable part of time and energy, these ends will influence, if not dominate, the choice of ways of making a living. Thus, for some men some of these ends at least provide the basis for the profit-seeking motive. For other men, and depending upon circumstances, these ends may be sought by other economic means as well as by some non-economic means. These rather universal desires, therefore, do have

the two aspects just mentioned: of providing the underlying basis for profit-seeking and of modifying and tempering the search for profits.

## THE HEDONISTIC CALCULATION

In discussing the profit motive, we noticed that the different aspects of that motive, such as the desire for stability of profits and the desire for the maximum amount of profits, were often in conflict; and at this different level of motivation we can likewise see that there is continual competition among these underlying desires or ends. Since they involve competition of satisfactions or elements of happiness, we speak of the process by which they are balanced and reconciled as the "hedonistic calculation." Admittedly, the term "calculation" implies a degree of rational balancing of alternatives which often does not exist. To an unknown, but surely considerable, extent men do not "think it out," and here we might better say that there is an unconscious warring for control of action between those underlying desires.

Indeed, in considering those non-economic desires there is a peculiar danger of mere rationalizing. When men are really impelled by the sheer desire for income and the material comforts which it will buy, they often try to explain their motivation in terms that appear more creditable in public opinion. But on the other hand, there is danger of rationalization in the opposite direction; frequently businessmen, at least among themselves, feel rather apologetic for appearing to be influenced by any motive other than hardheaded profit seeking. If it appears, as it often does, that their actions do not conform to this avowed purpose, they then fall back on long-run and broad-view justifications which one suspects conceal more than they reveal. On the whole, it is my impression that the tendency among business enterprisers to sheer rationalization is as great in the one direction as in the other.

If we try to get at the "why" of profit-seeking, the most obvious explanation is that those who are controlled by it want to "make a living." This objective covers the desire for the goods and services that money will buy for one's own use and

that of one's family. It thus involves self-preservation and parental love. These minimum and almost universal bases of motivation, however, need not detain us, for they are believed to have little effect on the choice between working for others or assuming the role of the enterpriser. We are concerned with the motivation that leads or may lead men to expand the economy through the establishment and expansion of business concerns.

## POWER

This desire can be described in various terms. For some, the term "power" carries an unfavorable connotation which would be avoided if we were to use the term "influence" or "leadership." What we have in mind is the rather universal desire to direct or influence affairs in the way one would like to see them go—a way which may, of course, be for the satisfaction of self-regarding impulses or the most unselfish ones. Indeed, some of the most notable examples of people who are prompted to an unusual degree by this motive are those who would use their power for purposes which they would regard as highly unselfish. It is such a motive that often characterizes successful religious leaders, political leaders, and teachers, many of whom cannot be charged with the desire to use their power for their own personal advantage. These remarks are intended as a denial of any implications that it is an unworthy motive.

There seems to be no question, however, that it is a desire which characterizes some people much more than others. Moreover, men seek power and influence in the ways which are appropriate and feasible, and these most appropriate ways will vary from time to time and particularly will they be influenced by the kind of social organization in which the men live. In the most primitive society, power might be yielded by physical prowess and skill in combat. Under other circumstances, the most promising line might be the control of the state (one which holds high attractions at the present time); at other times such power would most readily be gained through the control of the church or through the ownership of land. Many other ways of gaining power exist and have at times been most promising. For example, power may be gained by personal charm, a means which Cleopatra is reported to have used to great advantage.

In the society of the present and recent past, however, a prominent and feasible way of satisfying this urge is through business. A good case can be made for the view that under certain conditions this method is more socially fruitful than almost any other. These conditions include a workable degree of competition, reasonable intelligence and information on the part of buyers and sellers, and a fair degree of mobility of labor and the other factors of production. In the absence of these conditions, economic power may be gained by attaining a monopoly; and it may be used to restrict production by deluding the consuming public or the sellers of supplies or services or by taking advantage of a local oversupply of workers. That these tactics can and do exist in the actual world is true. To some extent the conditions which permit them are unavoidable; but in all of them, there is the possibility of improvement, though never of perfection.

But when the assumed conditions do exist and to the extent that we can look forward to a closer approximation to them, the road to power lies in serving the community well. The most obvious way to gain power as an enterpriser is to produce a good product, sell it at a reasonable price, and offer it at a time, a place, and in a method convenient and acceptable to the public. Not only is the most obvious way of securing power in our economic society consistent with the general welfare, but an added advantage is that the power conferred by the impersonal forces of the market is continually subject to reduction or revocation.

In comparing a system in which power is exercised by businessmen with other systems, we must always remember that in any system men are going to seek power and will secure more or less of it. The questions are how much they can get and on what basis it is gained and held. Shall power lodge with them because they have seized it and hold it through the help of an army or a secret police, or shall we choose those who are to be placed in power; and, if the latter, shall we choose them by votes at a ballot place or by our daily "votes" as we go to the market and bestow our approval on one rival by buying his goods and withhold it from another?

Business activities yield a satisfaction of this desire for power or influence in two major ways. First, business provides a means

of attaining wealth, and wealth gives power. In the second place, it yields power through the control or direction of people and resources within an organization. The former is the one which has been most frequently noted. For example, an excellent essay by Thorndyke, the psychologist, implies that businessmen seek and gain this influence through the possession of money.[1] There is no question that business does yield wealth, and the possession of great wealth does give power; but modern business also yields power in other ways. The president or any of the higher officers of one of our large industrial concerns exercises influence over a very large number of people in the daily direction of their work and in the decisions of what and how much to produce, quite regardless of their own personal wealth. Even in the field of finance, where such power is exercised by the control of funds, there are many examples of men whose influence runs far beyond their own fortune. An example of this influence through the control of funds rather than their ownership was the case of the late J. Pierpont Morgan, whose leadership in industrial affairs was quite out of proportion to his own fortune. A current example of power disproportionate to ownership is apparently that of Robert Young's position in the Allegheny Corporation and the Chesapeake and Ohio Railroad.

Business, then, yields this satisfaction of extended influence and leadership both as an activity and as a means of attaining wealth; and of the two, the former is of equal importance under our present type of business, and especially corporate organization.

The effectiveness of this motive for the establishment or the expansion of business can be seriously impaired by any considerable limitations in the rights and scope of management or by policies, such as tax policies, which are inimical to the accumulation of large fortunes through business activities. Of these two types of limitations, both of which are very real today, probably the former presents a more serious danger of dampening the normal incentives to business expansion than the latter. One reason for this conclusion is that the power of wealth is a

[1] "The Psychology of the Profit Motive," *Harper's* Magazine, Vol. CLXXIII, pp. 431 ff.

relative thing; if the possibility of accumulation were limited so that $10,000,000 represented the practical top, the competition and striving for that goal might be as great as though the top were $1,000,000,000. But limitations placed upon management in the control and direction of the affairs of the concern may well have the effect of impairing the attractiveness of enterprise, as compared with other means of earning a living.

Enlarged influence, both through the activity of business and its tangible fruits (wealth), is gained by the establishment of new businesses or the expansion of old ones. It is true that at certain stages in the development of an enterprise or of an industry, power may be enhanced by policies which are the opposite of expansion. Such are the efforts to restrict new entrants, to buy up and eliminate excess capacity, to prevent the adoption of new productive devices, and any of those restrictive schemes which aim at profits through scarcity instead of through abundance. A dangerous feature of an exchange economy is that the value of goods or services supplied can be enhanced by either of these methods. But these devices are, generally speaking, most effective for preserving a position already gained. A concern or an industry does not often *become* great and powerful by such methods, rather their adoption represents a use of power or an effort to keep it than a way of gaining it in the first instance. Furthermore, there are usually those who do not have such power and are eager to gain it. They seek power through expansion and thereby tend to prod into action any older rivals who, without this actual or potential challenge, might be inclined to rest on their oars.

In general, then, and on balance, the desire for power is an expansionist force wherever an economy is characterized by invention and innovation and by free experimentation and freedom of entrance. In so far as these features are preserved and encouraged, this basic desire can be made to work for expansion and progress. The implication for public policy is evident.

## PRESTIGE

This is the general desire for recognition by others. It is thus a distinctly social phenomenon. In the field of business this rec-

ognition may be desired and is obtained from various groups. In the first place, there is the desire for favorable recognition by other members of the operating organization. Since the members of the organization are those with whom the individual has most continuous contact, their approval rates high in the scale of values of the enterpriser or manager. It makes much stronger appeal to the operating man than to the investor. The desire for recognition may extend to the other businessmen who are engaged in the same field. This aspect is similar to professional pride. A superintendent or plant manager may value highly the opinion of men who are competent to judge the effectiveness of his own work; and judgments of businessmen (particularly of operating men but also, to a growing extent, of general managers) are made and valued on this score, sometimes without much regard to the profitableness of the enterprise. This relative submergence of the profit test may reflect the recognized fact that profits may be influenced by many factors beyond the control of the individual. On the other hand, it may mean that, in the scale of values of these managers and especially operating men, profits rate lower than other evidences of business competence. To the operating man, this prestige may rest upon the sheer efficiency with which a plant is run. With managers at another level, it may be based upon the evidences of healthy growth of the concern. Then there is the desire for favorable recognition by the owners, that is, the stockholders. And finally, recognition on the part of the general public is more or less highly valued.

It is to be observed that favorable recognition for the individual by most or all of these groups will depend upon the success of the enterprise. This fact leads to one of the most important observations to be made in connection with the motivation of businessmen and the possibility of influencing motivation, namely, that the individual tends to identify himself, and others tend to identify him, with the enterprise itself. Thus, in the minds of the general public, the importance of the president of a corporation depends largely upon the size and success of that corporation. While, as we have indicated, the measure of success may vary among the observers, probably the most im-

portant single sign is the growth of the concern. It is frequently more important than the rate of profit; this is shown by the prestige which the responsible managers of the largest corporation in its field will have even though the rate of return upon capital invested is very moderate. Indeed, in a number of cases, the history of a concern has shown that as it grew in size the profit rate declined. If profits were to be the sole test of success, the managers who were responsible for this historical development should be put down as poor businessmen. However, they are not so regarded and their prestige is very high if the concern has attained a position of leadership and particularly if it has come to be one of the largest enterprises in its industry.

This identification of the individual with the institution which he directs provides one of the important reasons for the individual's desire to expand the activity with which he is associated. The phenomenon is not peculiar to business organizations, for it probably contributes strongly to the general desire for growth which is observable in practically all kinds of human organizations. Thus, college presidents generally want larger colleges, captains want larger ships, ministers want larger churches, and emperors want larger empires. The tendency on the part of the public to identify the individual with his organization leads the enterpriser to make the same identification in his own mind; and it helps fuse the interests of those responsible for the enterprise into a loyalty for and interest in the business entity itself. As we shall see later, this characteristic of businessmen may have considerable significance from the point of view of tax policy, particularly as to its bearing on the relative effect of taxing the individual's personal income or of levying upon the business entity.

## SOCIAL APPROVAL

There is widespread desire among human beings to have the approval of their fellows. This is not quite the same as desire for prestige; prestige and power both imply a rank in some hierarchy of values, whereas social approval is concerned not so much with relative status or with the size of the enterprise as with a judgment of the activity itself. Social approval is,

so to speak, qualitative instead of quantitative. The desire for social approval may well be a minor factor in determining the expansion of an existing business, since such expansion is more likely to be influenced by other considerations, including the practical necessity of expansion in order to remain in the field. Social approval does, however, have a pervasive effect upon the choosing of occupations by young men. It may lead them to favor the field of business over one of the professions or to choose the career of an independent enterpriser over a salaried position. It may also have a bearing upon the decisions of successful and older businessmen to continue in their work rather than to seek positions in the diplomatic service or other governmental posts or to devote themselves exclusively to various philanthropies.

The business enterpriser, that is, the businessman who initiates changes and blazes new trails, is a leader in a large or small way. The situation in this country concerning the social approval granted enterprisers is very confused. On the one hand and among certain segments of the population, there is admiration for the efficiency of the business leader; this is indicated in the frequent demand for a "businesslike" administration of government and by the fact that in a national emergency, the demand is frequently made for a successful businessman to take over the reins. When businessmen do devote themselves to such causes, the social approval of them may be high indeed. We are a sufficiently practical people so that we highly admire the ability to get things done.

On the other hand, when the enterpriser's efforts and energies are devoted to private business itself, public opinion is less favorable, on the grounds that such efforts are motivated for purely selfish benefits. The man who organizes an industry and who, therefore, performs a vital function for the whole economy does not appear as a public spirited benefactor but as an individual profit-seeker. This attitude is inevitable in a private economy, for such an individual does not appear to be working for the public interest, and ordinarily he is not. The advancement of that interest is largely an unintended incident. But to say that it is incidental is not to say that it is accidental; in a

well-functioning market economy, the enterpriser's better use of resources which yields profits to him will also advance the interests of others—the workers in more jobs, the consumers in more and cheaper or better goods, and so on. But even so, the public may well doubt that those were the primary aims of the enterpriser, and thus the social esteem granted to his work is impaired.

Moreover, those who become recognized as leaders usually are successful in attaining these personal (selfish) ends. Indeed, if they are not successful in this way, they are probably not successful as leaders in any sense nor in contributing to the general welfare. Many people feel that it is bad enough that a person should try to make money above the general level of income and wealth—that he should succeed is worse. Holding these views, they arrive at this paradoxical conclusion: men who strive and fail or only moderately succeed are hard-working, worthy members of the community; the men who succeed most brilliantly are objects of lukewarm public regard or suspicion. The small businessman—for example, a retailer, who makes poor use of his resources—is frequently the object of a special solicitude on the part of the government and of popular opinion, as against the chain store or larger independent retailer who has managed his resources effectively and therefore succeeded in making profits.

Another fact in our system which reduces the general approval of business success is that the enterpriser who is most effective in economic expansion and most successful in the private sense is usually an innovator. In some fields of activity, the innovator enjoys the respect of the others in the field. The scientist who makes a discovery aids others to advance their own research and understanding. But an innovator in a competitive society is a leader in a peculiar sense. He must destroy the old ways in order to establish new ones. He is forever upsetting the apple cart, and the other people in the occupation are likely to resent this disturbance of the existing situation. He exerts considerable influence, but this comes through the unwelcome pressure upon competitors to follow in his course. These competitors are not likely, therefore, to be generous in acknowledging their

obligation to him. They imitate but do not glorify their model. The innovator is a leader only in the sense that he has followers whom he does not want. He would prefer that his superior methods of administration and conduct of business remain his alone and thus give him a competitive advantage. His original and successful ideas may yield a degree of envy and a certain amount of respect, but they are not likely to establish him "in the hearts of his countrymen."[2]

Moreover, businessmen have little history and tradition in comparison, for example, to physicians who proudly regard themselves as the inheritors of an ancient profession embellished by the great names of Galen, Hippocrates, Jenner, and Osler. Moreover, as Miriam Beard sagely remarks:

> If it is a little strange that writers have not yet provided a history for the business man, it is still more curious that he himself remains so unconcerned in the matter. For history is a potent weapon and a man who lacks one nowadays may be said to go unarmed. Aristocrats, dictators and priests have long appreciated the beauties and uses of history, for without emphasis on continuity they would be lost; they need the apparatus of song, emblem, legend, and ceremony which connects them with a venerable past, to hallow their persons and sustain their powers.

And regarding businessmen:

> . . . . Their past is of little benefit to their social position or personal morale. Any simple soldier in the rear rank may feel himself a hero because Wellington and Napoleon once lived and triumphed; any attic-aesthete may demand increased respect for himself and his products because Rembrandt and Beethoven cast their mighty shadows behind him. Not so the unfortunate manufacturer of pig-iron, the insurance broker, the peanut magnate, the czars of the corset industry—on *them* falls no glory reflected from Jacques Coeur and Jacob Fugger, the Medici and the Rucellai.[3]

[2] On this and other aspects of innovation see Joseph Schumpeter, *Theory of Economic Development* (Cambridge: Harvard University Press, 1934), *passim*; also Chapter 15 of this book.

[3] Miriam Beard, *History of the Business Man* (New York: Macmillan Co., 1938), introduction.

There are a number of reasons for this neglect of the business enterpriser by historians. For one thing, our concept of history has been influenced by the standards of past civilizations in which trade was held in low esteem. Moreover, the businessman rarely had the romantic appeal of the knights, the rulers, and the people closely associated with them. His outstanding characteristics have generally been thrift and shrewd calculation of risks; and the virtues which he has held in highest esteem have been those unromantic ones of "honesty" and "fulfillment of the contract." He thus cut a poor figure in history beside the more dashing gentry who endeared themselves to the commonplace people by the exploits of conquest, assassination, and chivalry. And present-day parallels can be found in the popular applause for the modern plumed knight or Robin Hood who would "take from the rich to give to the poor."

The world, for these and other reasons, has given less approval throughout history to the directors of economic affairs than it has to the people who enjoyed, without producing, the fruits of economic progress. The usual history of the Italian Renaissance, for example, deals primarily with the artists and humanists of that brilliant age. Secondary attention is given to certain members of the Medici family and others who, as the possessors of great wealth, acted as the patrons of the arts. But one has to search for references to the founder of the Medici fortune, a certain di Bicci who, with the craftsmen and humble workers, created the cloth industry of Florence and who later established the great Medici banking house, and thus provided the material basis for the glory and the artistic prestige of the city and people of Florence. So it has been through the ages that the rulers, warriors, and artists were accorded a higher degree of social approval than the enterprisers and their co-workers who organized, initiated and carried on the production that raised the general standard of living.

All of these considerations create a confused picture of the place of the business leader in public estimation. Our strong pragmatic sense, the admiration for an ability to produce results, enhance him in public estimation. However, the largely self-seeking motivation, characteristic of a private enterprise

system; the envy of wealth, whetted by a defensive attitude which is inclined to explain that wealth on the grounds of good fortune rather than ability; the peculiar position which the leader in business must hold relative to his followers; the lack of cultural and historic background—all these factors tend to detract from the social approval of the businessman. But, on the other hand, and disregarding for the moment the doctrinaire socialists, the enterpriser probably has enjoyed a higher position in the scale of public approval in recent times than he has ever before attained. This is not saying a great deal, for the trader until recently has held a low place in most civilizations. In the Chinese hierarchy he stood only a step above the warrior and decidedly below philosophers and scholars. In medieval Europe he stood well below many other classes in the society, particularly the members of the clergy, military men, and the landed aristocracy. In the latter part of the nineteenth century and in the early part of this century, the enterpriser's position in this country was high indeed. Perhaps the tendency in the opposite direction seen or imagined by some people during the thirties was the natural reaction to the high estimation and not very discriminating approval which business leaders gained during the prosperous twenties. If so, this reversal may prove to have been only temporary and healthful; it may point to the need for a greater sense of public responsibility on the part of businessmen, as well as to a need for an appreciation of his rôle by the public. The discrimination between business success resulting from constructive efforts and that arising from less socially fruitful methods is, of course, essential if business as a whole is to be assigned its proper place in our society. However, in view of the importance which the businessman holds in a free enterprise system, any general depreciation of his social function and economic role would be both unreasonable and unfortunate from the point of view of attracting the best abilities to the direction of our economic affairs.

## THE CREATIVE DESIRE

Successful businessmen, when they can be induced to analyze their motives, attach great importance to what they call a

"sense of accomplishment." This is a manifestation of the impulse to create something, a desire which is not necessarily supported by public recognition or prestige. This wish to create is like the artist's desire to paint or the inventor's desire to contrive. In the field of business enterprise, this pervasive impulse finds two outlets. One is simply an expanded form of the interest which the mechanic has in making a satisfying product—a manufacturer may have the same pride in the thing which he is producing. The other is an interest in establishing a successful enterprise quite aside from the product produced by it. The founding and firm establishment of a stable, well-organized concern which enjoys the loyalty of its many participants and the respect of other businessmen is regarded by many as an outlet that can and does yield high satisfaction. The creative impulse in both manifestations, and particularly the latter, leads to a jealous regard for the well-being of the enterprise. There is plenty of evidence of the strength of this motive in the continued service of business leaders after they have reached the point of financial independence.

The desire to create an enterprise is enhanced by the challenge of obstacles of a certain kind and up to a certain point. The obstacles that are unavoidable, such as meeting competition or overcoming the technical problems of an industry, are quite consistent with this creative impulse and, indeed, may stimulate it, whereas obstacles that are regarded as arbitrary, capricious, unnecessary, and unpredictable serve to dampen it.

### THE COMPETITIVE IMPULSE

This impulse has sometimes been described as "pugnacity" or "the spirit of the game." In this general sense, it is a prominent characteristic of the American people. It is reflected in our love of games, both as participants and as observers. One of the ways in which this impulse has manifested itself is in the rivalry of business. Business is popularly described as a game—a description which is far from accurate in many respects but very revealing as to its competitive nature.

Fundamentally, the existence of competitive attitudes is a special manifestation of the general spirit of a people. It is im-

possible to determine what accounts for this quality and spirit. We can observe that it has been strong among some peoples in some ages but that more often it has been at a low ebb and submerged by an acceptance of status and a search for security. The age of a people may have something to do with it, that is, the average age of living citizens and the age of a civilization and a people as a social unit. The former is significant because young people and those in the vigorous stages of life are likely to be more attracted by a contest, whereas it is supposed that older people will normally attach more importance to security and, because of a sheer decline in energies and animal spirits, be less eager to enter the fray. The age of people as a social unit is important because history seems to indicate that, when a society has existed in a certain place for a long time and without any radical changes in its structure, there is a tendency for the social and economic classes and for individuals and families within those classes to gain established and protected positions. Such a social rigidity is evidently not conducive to active and widespread competition. This does not imply that there is anything inevitable about this trend; but if it is to be avoided, conscious effort should be made to that end. Modern factors which are likely to discourage this stratification of society are science and the growth of technology. For in the presence of these forces, old methods are constantly being challenged by new ones. Moreover, with the growing consciousness of social trends and the efforts of peoples to control their destinies, this social rigidity may be avoided in the present and future. However, the apparent decline of the individual competitive spirit in some of the western European countries in recent decades must, probably and at least in part, be explained on such evolutionary grounds.

Although this competitive spirit is relatively high among American businessmen, there are many cases in which it is modified or submerged by other desires, such as the desire for maintenance of an established position. This may be a kind of perversion of the competitive attitude. Just as a football or basketball team may try to "freeze" the ball when they are winning, so may those business concerns that are in the lead attempt to preserve that position. It is generally recognized in the sports

mentioned that, when this motive dominates, the game becomes dull and uneventful; and, therefore, rules are made to discourage the practice. Such should be the policy as to business, and the antitrust laws are directed to that end.

Moreover, there are some forms of competition which seem to be futile in helping a competitor get ahead in the game. Direct price competition between a limited number of producers of virtually identical products may be a case in point; for here, if one producer lowers a price, the others will of necessity meet that reduction. The reduction, therefore, would fail to yield any competitive advantage. Under such conditions, there may be efforts to agree on prices or, more likely, an armed truce will grow up under which each competitor is discouraged from making a move to lower prices. Whether, in fact, there has been a decline in genuine price competition in this country it is hard to say. Some writers think that there has been such a decline, and they talk about a "decline in competition." It should be recognized, however, that a decline in price competition may not represent a decline in the competitive spirit at all. That conclusion seems to be fortified by the fact that when active price competition declines there is a tendency for other competitive methods to be intensified. These may be competitive efforts to secure dealer outlets, improvement in the quality of the product and in the package in which it is presented, better service to the dealers and to the consumers, more extensive advertising, and a multitude of other factors. We will later inquire into the efficacy of these forms of competition regarding the general welfare. But here the argument may be anticipated to the effect that the developments of recent decades which have contributed to the raising of the American standard of living have been even more in the introduction of new products and the improvement of old ones than in the direct price reduction of staple products. In any event, for our present purpose, it should be recognized that competitive motivation can show itself in many ways. The problems of public policy would seem to be, first, to discourage and help prevent the competitive impulse from working itself out in the form of "freezing the ball" and, second, to encourage the channeling of competition toward results that will be

generally beneficial. But from the long time point of view, an even greater problem is the preservation of a type of economy in which the prizes will be sufficiently large and the field sufficiently open so that the competitive spirit will not languish. For a free society must be a competitive society; and no amount of laws, administrative bodies, or other forms of public control can serve to maintain such a society if the competitive spirit itself languishes.

## INDEPENDENCE

A reason most commonly advanced by men who have established their own businesses is: "To be my own boss." This desire for independence is perhaps a variant of the desire for power, but it has some special characteristics. The desire for power may be better satisfied by occupying a responsible position, such as that of department head in a very large organization, than by owning and running a smaller business. Moreover, the desire for independence is more likely to lead to the establishment of new businesses than to the expansion of old concerns. Indeed, the expansion of a business may actually reduce the individual's independence because such expansion commonly involves taking in partners, selling stock to outsiders, borrowing of funds from banks, and perhaps a greater degree of control from labor unions, the government, trade associations, and other agencies. With some notable exceptions, the most highly independent businessman is likely to be the small businessman. On the other hand, a desire for independence by a firm may lead to expansion, particularly expansion through integration, that is, the owning of successive stages in an industry either by purchase or by building.

Independence as a basis for seeking a career as a business enterpriser and for expanding enterprises is particularly subject to influence by public policy. In the complaints businessmen make and in the deterrents which they think operate against their expansion, the interference of government and labor unions rates high. Actually, the importance attached to these annoying regulations is often greater than can be explained by their probable effects upon profits. This fact suggests that the influence of

these interferences is based upon something other than the pure profit motive.

In an interdependent society, it seems clear that many limitations must be placed upon this independence. But broadly regarded, perhaps the greatest problem for the successful functioning of a free enterprise system is how to combine a reasonable amount of independence with a proper regard for the social requirements; for if we cannot reconcile these two objectives, we must expect that able young men will more and more tend to choose the equal financial prospect and greater security of salaried positions with existing concerns rather than the headaches and frustrations of entrepreneurship. This balancing of considerations is very real if one observes the reactions of young men graduating from our schools of business administration. These young men are in a good position, both by mental habits and by opportunities, to make a deliberate choice; and to a preponderant extent, which is disturbing to some educators, they choose the role of a salaried man over that of an independent enterpriser—and not only as a temporary apprenticeship but as an anticipated lifetime career. There are a number of reasons for this, including the kind of education they have received and the practical problems of securing capital; but there are other reasons that involve basic motives. One of these is that the independence of the enterpriser is not so great as it once was; hence, this way of earning a living is less fruitful in satisfying one of the basic desires.

## SOCIAL OBLIGATION

Mixed with the previously mentioned ego-satisfying incentives, there is sometimes a sense of obligation which is imposed by virtue of an established position in business. This obligation is not likely to extend to the establishment of a new business because at that stage any general feeling of obligation would have to be toward society or the community as a whole; and, therefore, it lacks the force that may attach to it when the individuals who would be affected by business decisions can be more clearly visualized.

However, when a business has been established for some

time, it and its directors may come to feel a sense of obligation to employees, particularly to those who have been more or less permanently associated with it. This consideration may be a very real one in activating directors of business to strive to maintain employment during a period of depression; it may also provide one of the spurs to expansion and growth. Some manufacturing organizations make quite a point of the combined efforts of their managers and permanent employees to conduct the business so as to provide security and opportunity for advancement. This avowed policy apparently has real value in the maintenance of good industrial relations, when supported by the evidence that the management over a period of years is really following it.

This feeling of obligation is, of course, usually mixed with self-interest. In some of the cases described, worker loyalties have been a source of envy to other concerns. In a sense, all those actions which we commonly regard as unselfish really result from an ever extending concept of one's own self-interest. With all people to some extent, and especially with some who are peculiarly endowed with imagination and foresight, the concept of "self" is extended to, and becomes absorbed in, certain groups or even to the whole society. It is through this extension of self-interest that we can most realistically hope for an increasing influence of social and public considerations in individual decisions.

In some of our largest organizations there are notable potentialities for this conscious fusion of public and private interest. When an organization reaches the point where it is selling its products to a very large part of society, the view becomes more and more plausible that the prosperity of that society is a matter of very direct interest to the organization. Our large industrial organizations cannot, like little pawnshops, hope to make profits from the misfortunes of their customers. Likewise, any large organization is forced to consider the effect of its own decisions upon the whole community to a much greater extent than is the corner grocer or the small manufacturer. We have here a factor which is somewhat analogous to the development which economic theorists have observed toward oligopoly and

monopolistic competition. That theory rests essentially on the observation that, when an organization has grown to a point where it supplies a considerable part of the market, it will no longer establish its prices and production policies with regard only to its own self-interest to sell its goods; such a concern must take into account the fact that its own price policy or production policy is going to have an important effect upon the market in which it operates. Thus, one of three large automobile manufacturers must have a regard for the effect of its production and price policies upon the condition of its market, a consideration which an individual wheat farmer could afford to disregard. In a somewhat analogous way, the large concern is forced to take into account the effect of its own wage policy, its continuity of employment, and the expansion of its business upon the whole economy, because those effects may be pronounced and will be significant in determining its own sales potentials. A notable example of large businesses finding it necessary to consider the effects of their decisions upon the whole economy is provided by the price policies followed in the automobile industry, the steel industry, and a number of other industries in the period following the second World War. It seems quite clear that the prices which were asked for products of such industries were less than pure market forces would have made possible. The evidence of this was provided by the widespread development of "gray" markets in which the products were bought from the industries by intermediaries and resold at higher prices. Undoubtedly the motivation was complex in that it involved public opinion, the possible effect of price advances on wage demands, and the general effect upon inflation, which was widely feared at the time.

This is equivalent to saying that, when business units become very large, there is a possibility that business leaders can really lead and are not mere impotent chips on an economic stream. There may be a difference of opinion as to whether it is desirable for business leaders to try to influence the economic environment in which they operate. There are those who believe paradoxically that businessmen will be best serving the social interest if they proceed with their job of cost reduction and product improvement without regard to the social consequences of

their action. For example, in the postwar pricing problem just mentioned, there were those who felt that it would have been better for the manufacturers to take the prices which the market indicated rather than to let the gray market develop. We cannot appraise that judgment at this time, but it does suggest the kind of question that arises when business leaders try in all good faith to be business statesmen. This skeptical view constitutes a healthy antidote to a possible excess of sentimentalism. In a condition of perfect or atomistic competition, we could share this view; but because of the size and influence of some of the modern concerns, a conscious recognition of their influence upon the whole society, which comes very close to a feeling of social obligation, may serve the community well.

A moment's reflection will indicate that all these basic desires, which we have been considering, are neither worthy nor unworthy in themselves but that they may be directed to good or bad purposes. The social problem is to arrange the environment and the framework for individual efforts so that they will serve constructive ends. For example, acquisitiveness and the desire for power can be directed toward production and prosperity or toward scarcity and destruction. This problem has always faced those economists and social philosophers who desired that individuals be allowed to seek their own objectives. Adam Smith, for example, spoke of the "divine hand" which guided individuals in seeking their own self-interest in such a way as to advance the general interest. It should always be remembered, however, that there are certain conditions of competition—mobility of labor and knowledge of the market—which are assumed to be necessary in order to bring about that happy result. It may be that the problem of statesmanship is to establish those conditions to an even greater extent; on the other hand, it may be concluded that those assumed conditions are either impossible or would not lead to the desired results. In any event, if enterprisers are to be allowed to choose their own courses of action, and if we are to be concerned with those actions from the point of view of social welfare, the elements of the problem lie in the basic desires and mainsprings of human beings.

In the industrial labor group, there has been much study of workers' incentives with a view to improving production and

other desired ends of industry. These efforts, it is believed, have been fruitful. There are numerous illustrations of the fact that some employers pay exceptionally high wages and still fail to get the loyalty or the best efforts of their workers; while others, by establishing better human relations, secure the desired effectiveness and loyalty even though they pay only average wages. If the policy of drawing upon non-economic incentives as well as on the financial reward is effective with workers whose jobs are highly standardized, it would seem to be even more applicable to enterprisers and to young men who in contemplating their careers must choose between entrepreneurship or a salaried position. At least a consideration of these motives, even if they are not correctly classified and analyzed, should impress upon us that enterprise is not an abstract thing; it is the body of decisions and actions of men who freely choose to undertake this way of making a living. The problem at any time, therefore, of calling forth an adequate supply of enterprise is not purely mechanistic, nor can it be solved by economic devices alone any more than the loyalty of workers or of any other human beings can be obtained solely by those devices.

## ETHICAL STANDARDS OF BUSINESS

To understand the motivation of business enterprisers, we need to note not only their desires as they have been listed above but also certain characteristics of their ethical views. The ethics of business are not essentially different from those of the rest of a modern community; but that is because our whole civilization has generally adopted a set of ethical standards which are consistent with, and to some extent the historical result of, the requirements of business. It is not surprising, therefore, that some of these standards weigh more with businessmen than with the rest of the community.

To appreciate what these standards are requires that we note the fact that ethical standards do vary from time to time and from place to place. There have been times, for example, when generosity and charity have been rated at the very top of the scale of virtues. There have been times and there are places where respect for parents and ancestors hold that position of primacy. During the Middle Ages, probably the first of the

virtues was loyalty. The whole structure of European civilization rested upon the loyalty of each individual to someone above him in the hierarchy: the serf to the lord, the lord to his king, the king to his emperor, and the emperor to God. This ideal of loyalty, along with the other medieval virtues of chivalry and knightly honor, was not sufficient for the requirements of business. For business is based upon contract rather than upon status, and the notion of the *quid pro quo* is essential to the conduct of business. Accordingly, as commerce developed, the greatest virtues came to be the fulfillment of the contract, living up to one's word, fair dealing, and ordinary earthy honesty and integrity. We often refer to these as "sterling" qualities. It is revealing to notice that this is a trader's term which describes a unit of exchange, the pound sterling, in which businessmen have long had confidence. Moreover, some scholars trace the word to "easterlings," which was the term applied by the English to the medieval traders of the Hanseatic League, who, in their contacts with the then agricultural England, did much to establish commerce and the ethical standards of business in that country. These virtues, so highly regarded (if not always observed) by businessmen, became the keystone of our ethical system and particularly of the concepts of right and wrong among businessmen. The violent reactions of the business community to "changing the rules in the middle of the game," to anything that appears to be an abrogation of the contract, to a fiscal policy of government which appears to violate "the bond," or to any substitution of administrative judgment of expediency for the rule of law are at least partly explained by the ethical standards which are more or less common to our whole civilization but which peculiarly characterize the thinking of the business community.

A good society, obviously, needs more than these virtues of the market place. It needs mercy as well as justice, generosity as well as honesty, and mutual aid as well as self-reliance. A social environment and culture conducive to the expansion of business enterprise does not have to be one in which the ethical standards of business exclusively prevail; but at the same time, it must be one in which they are respected in word and in fact.

# 6

## *MOTIVES OF MANAGERS AND INVESTORS*

If it were always and completely true that managers identify their interests with those of their firm, there would be no need for looking at their personal interests. However, it is obvious that there is not such a complete identification of interests. The managers are, after all, individuals; and they have their personal interests. Those interests can be advanced in two ways: first, by growing up with and sharing the increasing prosperity of the company; and, second, by improving one's position within that company. The problem of good executive personnel policy is to reconcile, or to harness, these personal motives so that they will contribute to the well-being of the firm and to the realization of those business motives which, as we have indicated, characterize the business firm itself.

### ECONOMIC CALCULATION OF MANAGERS

The monetary interests of managers are, of course, to get more income and to gain security of that income. The desire for enhanced income can be made to serve the interests of the enterprise by seeing to it that financial gains will be given on the basis of merit—meaning the contribution which the individual manager makes to whatever motives control the enterprise itself. Obviously, no detailed rules can be laid down; but it seems clear that any rule or general policy of advancement of executives on the basis of seniority would defeat such an end. Many firms attempt a direct reconciliation of these motives by the use of substantial executive bonuses. When these are based upon profits and paid to individuals whose decisions have a material effect upon profits, they have considerable merit. Another device

is that of encouraging stock ownership by managers, either as a result of stock bonuses or by other means.

As to the manager's desire for personal security, there is a danger that it will lead to a policy of extreme conservatism. There are, unfortunately, many private and governmental institutions in which that comes to be a controlling motive of managers. To overcome it requires understanding and discriminating observation by top management or, as to top managers themselves, by a committee of the board of directors or by principal owners. Clearly, a policy of allowing "only one mistake" is likely to aggravate this natural tendency. Moreover, the administration of salary and promotional policies at the managerial level deserves more than casual attention or a policy of letting nature take its course in the blind faith that somehow the most able will reach the top. It may be suggested that the subjects of industrial psychology and personnel administration have been devoted too exclusively to the problems of the working force. They can, with equal profit, be applied to higher levels.

The problem of incentives for executives has more direct significance for business organizations themselves than for the public, although in recent years the salary and bonus policies of large corporations have become a matter of concern to the courts and to certain administrative agencies of government. In considering the value of such plans, it is necessary to understand the driving forces of men at the higher levels, and the effectiveness of the plans in drawing upon those forces, to the end that they will contribute to the dynamic qualities of business.

## MANAGERS AND OWNERS

One of the aspects of the development of the large corporation which has had considerable practical significance has been the wide diffusion of ownership of these institutions. This development was not anticipated by the early economists. It has arisen because of certain features of the corporation and of certain changes in the economy itself. Under the corporate form, the part owner (the shareholder) as an individual has no responsibility, with some local and special exceptions, for the

debts of the corporation beyond the value of the share which he owns. Moreover, the corporate form facilitates the division of ownership into very small units, represented by the shares of stock. To facilitate the transfer of these shares, the great stock exchanges and the intricate systems of brokerage and rapid communication have been developed. These features of the corporation and of our modern economic society have facilitated the investment of funds in large or small amounts and the ready transfer of ownership to other investors. Another factor favoring the wide diffusion of ownership has been the relatively high economic status of the large middle class in this country and the possession by the members of that class of savings which are available for such investment. For these and other reasons, we have witnessed an extremely wide participation on the part of the general public in the ownership of our large corporations.

In a sense, this situation has brought about the socialization of the corporation, and it thus represents a trend toward democratic capitalism. This process has gone so far that, in a number of our largest industrial concerns, there are more owners than there are employees. The picture, therefore, of a single capitalist or a small group of very wealthy capitalists employing thousands of workers is not true to the facts. There are certain important social values in such an arrangement, particularly in the effect which it has had toward, and in its still greater potentialities for, avoiding the economic class cleavage between owners and workers that was visualized by Karl Marx and some others in past generations.

But with this diffusion of ownership, there have come two necessary corollaries. The first is that investments in such enterprises are commonly made on a less personal basis than that which exists in an individual enterprise or a partnership. This is partly because, under the limited liability rule and the possible small investment of each owner, it is not so important that each owner be personally acquainted with the other owners and with the managers of the enterprise. The second corollary is that a separation of the functions of ownership and management has arisen. It is obviously impossible for a hundred thousand owners to manage a company directly. The large number of owners

alone would prevent it, but there is the additional fact that these individual owners frequently have stakes in a number of different concerns and obviously cannot, therefore, devote much time to any one of them. These facts militate against even a true *delegation* of authority to hired managers. Instead, the managers have gained a high degree of independence not contemplated in the legal concept of the corporation. This result makes it necessary, in attempting to explain the motivation underlying the conduct of large-scale industry, to recognize that the people who are most influential are frequently seeking ends which appeal to them as managers rather than as owners.

These interests are somewhat different, although not necessarily opposed. In the first place, the interests of the two may be different as to the scale of operation of the enterprise. Managers per se are likely to be interested in increasing the size and scale of operation of the concern, for they derive certain advantages from that growth, to a certain degree, independently of any accompanying effect upon profits. The managers' power is directly related to the size of the organization. Also, the salaries of the management group, and particularly of top management, appear —aside from chance variations—to vary with the size of the company (measured by capital employed) and with volume of sales rather more definitely than with the rate of profits. The managers' financial position is enhanced by maintaining the existing scale of operations and even more assured by the growth of them. Vice-presidents of large companies commonly receive higher salaries than do vice-presidents of smaller companies.

Growth has a similar effect upon the possibility of promotion. As an organization grows in size, there is a natural tendency to promote men within the organization to fill the newly created positions in the upper brackets. This is not always done, but still the generalization is probably justified that one's chances of promotion in a growing organization are better than in a static organization.

Moreover, the managers are in closer contact with actual operations and derive greater satisfaction from building a modern and efficient plant and organization and from adding new and technically better products to an existing line. These are

two separate objectives, both of which serve to satisfy what has been called the "instinct of workmanship." The active head of an organization and his assistants do derive, to varying degrees, much the same satisfaction from producing a product in which they can take pride and identifying that product with their own concern, as an individual craftsman derives from his product. In addition to this, the pride of workmanship can be satisfied by the establishment and development of a smoothly functioning organization. This latter satisfaction gains in relative importance as the work of the enterprise becomes more subdivided, and the manager, therefore, has less to do with the actual craftsmanship and more to do with the co-ordination of the efforts of others.

These satisfactions are only partially dependent upon profit making. Managers commonly do justify the urge to expansion in terms of profits. Indeed, the one does often contribute to the other; but, if we are seeking real reasons for action, we must recognize that this justification may be largely a rationalization of other motives. At any rate, it seems clear that managers have some desires which apply particularly to them and which urge them on to expansion. Whether this urge has socially desirable effects on the allocation of resources and in other ways may be debatable, but it apparently does contribute to a dynamic and expanding economy.

To the owners of large organizations, expansion may appear in a different light. If they are large stockholders, such expansion may have the effect of reducing their degree of control. Whether or not this happens depends upon the method of providing the additional funds for expansion. If these funds come from the plowing-back of earnings, the relative position of owners may not be affected. If, however, the funds are raised by sale of stock to the general public, the owners will be affected and the original owners' control will be "diluted" as it also would be reduced in a less direct way by the incurring of indebtedness to banks or bondholders. Furthermore, even though the growth of the organization may lead to a corresponding growth in profits, it may not lead to increased *rate* of earnings. To the owners, especially when they are small owners, the size of the concern or

the volume of sales gains importance only as these affect the amount and security of their earnings and principal. To the managers, the factor of size is important in itself.

Another respect in which the attitude of owners and managers may differ is in the relative emphasis placed upon the protecting of assets or increasing of income. Between some kinds of owners and some kinds of managers, no significant differences may exist; but with a certain type of owner, there may be a degree of conservatism that is in conflict with the more aggressive attitudes of the management. It has been alleged, for example, that the history of the United States Steel Corporation has shown a tendency at certain times to conservatism which was dictated by financial control rather than by the desires of the "steel makers."[1] The distinction, however, can be easily overstressed; for in a competitive industry, or even in a society in which various industries are competing for the consumer's favor, the ideal of conserving what you have and of moving ahead may come in practice to very much the same thing. The experience of certain large companies which have attempted to avoid the risks of change suggests that in a dynamic economy such a policy is itself risky and dangerous.

A general statement of the divergence of point of view, in so far as it exists, is that the managers' interests are more complex and varied. They include pride in the plant itself and in the maintenance of harmonious and pleasant relations between the members of the staff, interest in the welfare of workers, and pride in the tangible product. The owners are interested in all of these things in so far as they contribute (and for the most part, they do contribute) to the profitableness of the enterprise. They also have some interest in these matters for their own sake; but because of their less direct contact with them, it can be assumed that this interest is less effective.

These divergences should not, however, be exaggerated, and especially not to the extent of concluding that managers are commonly unfaithful to their obligations to owners. Generally speaking, it could probably be said that the managers are rep-

---

[1] *Fortune*, Vol. XIII, No. 3 (March, 1936), pp. 59 ff.

resenting the best interests of the owners as they see them. It is somewhat like the relation of the doctor and the patient, in which the differences of views center around means rather than around ends.

The manager has commonly as great a stake in the success or failure of particular ventures or the enterprise as a whole as the individual owner. Furthermore, the length of time encompassed in his interests is fully as long. The manager has frequently been connected with the enterprise for a long time and normally expects to spend the rest of his life with it. He has an absorbing interest in the growth and the profitableness of the company, for his own progress and his advancement within the organization will be conditioned by that growth. The interest of some owners of large corporations extends over an equally long period of time; but there are also many who are owners only in a transitory sense, as they buy and sell the securities of the company on the exchanges. These temporary owners, and to some extent the others, can dispose of their equity with a simple telephone call to a broker. There are notable exceptions, of course, on both sides. Some managers may be "floaters"; and, of course, some owners have their long-time interest irretrievably involved. It seems fair to conclude, however, that, generally speaking, the length of view of the managers as a group is fully as long as that of the owners.

Perhaps the best summary statement is that the managers give their loyalty to the corporation as a sort of independent entity. They wish to see it grow and prosper and yield profits partly because those profits are the mark of a successful corporation and partly because the profits provide the necessary funds for the continued healthy growth of the corporation in competition with others. Clearly, these are ends in which the owner, at least the long-time owner, is also primarily concerned.

In these modern developments the psychological aspects of ownership as well as of management have changed. This change has greater significance for the popular conception and support of capitalism than is generally recognized. The change can be suggested by recalling that in a primitive society some of the most important forms of private property were very closely

associated with the owner himself. For example, in the case of a man and his defensive armor, it was natural to identify the latter with the former, for it was almost an extension of his own person. And so it was with the spear or sword which the man owned and his productive equipment, such as a spade. In these simple cases no elaborate reasoning was required to justify the right of the owner to the exclusive control of the thing owned—hardly more so than to justify the control of his own right hand. Something of this identification persists in the case of the individually owned business plant, such as a small independent store or the small individually owned machine shop, which is the owner's means of doing business. But for a considerable part of our economy today, it is common for the individual owner to possess an engraved paper which he keeps in his safe deposit box which represents 0.00001, or some other infinitesimal share, of certain legally defined rights in the institution (the corporation) which is itself a legal creature. The attitude of the owner toward this piece of paper and the legal rights which it gives him and the attitude of the general public toward that property right is naturally different from what it would be to a tangible thing closely identified with the owner. This situation, incidentally, may help to explain the declining respect for property rights per se and, correspondingly, the decline which some observers believe they see in the support for the mores and institutions of capitalism.

But be that as it may, these changes in ownership have the effect of weakening the interest of an owner in the thing itself; he can hardly have a keen personal pride and identification of "his" property with himself if that property is a manufacturing plant which he has never seen and which produces products with which he is only vaguely familiar. His interest in the enterprise comes to be almost entirely rooted in the financial end results of the enterprise, and the non-economic motives and interests in production become diluted in many cases to the vanishing point. This fact provides a basis for the complaints made by critics of absentee ownership and of production for profit instead of production for use. What these critics frequently do not

see is that those consequences flow not from the concentration of ownership in a few wealthy capitalists but rather from the very tendency to widespread ownership of productive concerns, which many of them would applaud. That these tendencies have not gone farther and virtually eliminated the personal and human interests in production is due to the increasing influence of the managers; for to the manager, the plant itself, the workers in it, and the personal relations between the workers and between the workers and the managers are still very real things, not because managers are more interested in human values but because their work brings them in daily contact with the process of production and the thing or service being produced. From this point of view, therefore, the growing influence of this group of professional managers is not, as some writers seem to imply, a dangerous and unfortunate trend. It is, instead, the saving force which preserves, in a highly subdivided economy, some of the human values which we associate in retrospect with the individual craftsman or with the small owner, his few associates, and assistants.

This tendency toward an attenuation of the interests of owners in the affairs of their companies has gone so far that the managements of some companies have become concerned, and efforts are being made (for example, by the General Mills and Pepsi Cola companies), to enlist the broader interest of stockholders. To this end, regional meetings of the stockholders are instituted with all the allurements of entertainment and refreshment—a strange situation indeed, when the hired men have to use such devices to interest the owners, legally the bosses, in the affairs of their company.

We should also note that, in many small and medium-sized companies, owners and managers work closely together. The motivation of the two comes to be nearly identical, and, indeed, with small companies the owners commonly assume the active management. This fact is paralleled, to some extent in the case of large companies, by a tendency for managers to "buy into" the company and by the definite policy of some large companies to encourage stock ownership by the managerial

group. In such cases divergences of interest are, in practice, neutralized by combining the interests in the same persons.

## ECONOMIC CALCULATION OF INVESTORS

It would be quite arbitrary to try to discuss the special motives of all capital suppliers. Regarding the use of a considerable part of the funds for expansion of enterprise, we have indicated that they come from the business enterprise itself through the reinvestment of earnings. The motives which control this type of "investment" are the same as the general business motives for expansion. Then there is another class of investment in which the same mixture of general business motives and investment motives are involved, namely, the investment of the surplus funds of one business organization in the establishment or expansion of another. This intercorporate investment in most cases is probably prompted by special objectives, such as mergers or quasi-mergers, or by such business motives as the desire to support or to control a good supply source or a good distributing outlet. A third class of investment is represented by the funds provided by owners who are also managers.

But after all these sources of investment funds are recognized, there is still the group of outside investors who provide funds for enterprises over which they exercise little or no control. There is, in fact, no way of distinguishing these investors by their legal status; they may be either minority stockholders, bondholders, silent partners, individuals who lend to an enterpriser on personal notes, or even banks which provide equity funds for some businesses. The legal distinction is not important.

The motivation of investors, of course, involves a combination and balancing of considerations. Peculiarly in their case, the balancing of risk and prospective reward is involved. It is worth while to recognize, even if we cannot measure, the separate desires of these investors.

*a*) *Desire for Current Income.*—One of the important objects of investment is to put funds to work so that they will currently earn an income. Because of the high degree of risk and the necessary developmental expenses of establishing a new business, this incentive is not likely to lead to financial aid in the starting

of new enterprises. It will be better served by buying into companies which have passed through the perils of infancy but which have not become so well established as to be in the "blue-chip" stage; for in this latter group, while security may be high, the income will be correspondingly low. The fact seems to be that the incentive of current income leads chiefly to the providing of funds for established companies. It thus serves to make possible an expansion of those companies or to relieve the originators of the enterprise of all or part of their equities; and perhaps in this way, it enables those originators and their funds to perform again their creative function. Thus, the investments made under this motive enhance the mobility of capital and *indirectly* make possible the establishment of new businesses and *directly* aid in the expansion of existing businesses.

*b*) *Desire for Future Income.*—Individuals who are in the prime of their earning power may care little for the added current income of investment; but they may be moved by the desire for an income when their personal earning powers decline, either because of the predictable event of retirement or the contingencies described as the "rainy day." How importantly does this desire contribute to the establishing or the expanding of businesses? In the case of the farmer or the small businessman, it may lead directly to expansion of the business, for the business may be regarded as a source of future income. But in recent decades, this desire for future income was served, for a large part of the people and their savings, by the purchase of life insurance or annuities. Thus, funds used to insure future income are not directly channeled into economic expansion. Whether they will indirectly serve that purpose depends upon the policies and limitations placed upon the investments of these institutions. This suggests a serious problem. Perhaps its solution lies in a return to the earlier policies of the original investment trusts, under which the required security was gained through diversity and which still permitted the use of institutional funds for productive purposes. It may be, although it does not seem to be probable, that the increasing role of the government in providing for the needs of old age and the "rainy day" may reduce insurance saving and solve the problem in that way. But for the pres-

ent, it would seem that the best results are to be expected from liberalizing the investment of funds entrusted to such institutions rather than from anticipating or striving for a reduction of funds placed with them.

*c) Appreciation of Principal.*—The desire for enhancement of principal is not entirely distinct from the desire for income. With certain classes of investors, *current* income can be provided by buying equities or obligations at a low price and selling them at a higher price; for some other investors, appreciation of principal is closely related to the desire for *future* income. The latter is a motive which commonly appeals to those investors whose incomes are more than adequate for current needs. In any case the prospect of investors committing funds to new enterprises is often dependent upon their hope of capital appreciation; and that hope is directly affected by tax policy. Men in the financial position to make such investments have said that a low tax on long-time capital gains combined with a substantial tax on current incomes would encourage them to invest in young and promising ventures rather than in the seasoned securities of well-established concerns. Their reasoning is that, since they are in the upper brackets of the personal income tax, added current income loses its attraction. It might be better for them to exchange current income for the prospect of capital gains which, under the assumption just made, would be subject to a lower tax rate. A reduction of taxes on both personal incomes and capital gains would not serve this purpose as well as a differential in favor of capital gains. The encouragement would be still greater if the tax on new enterprises could be reduced so that the prospect of such enterprises' providing the desired capital gain would be improved. At any rate, this desire for an increase of principal in relation to the desire for realized income has obvious significance if we wish to adapt a tax system to the encouragement of new enterprises by the provision of new funds, especially from large private fortunes. This desire also gives special significance to the general state of business optimism, for the hope of capital appreciation, even more than the other economic motives, requires a favorable expectation for the future.

The hope for capital gain is in some ways supported by other

interests of the investor, such as the desire for future income; but in other ways, it is opposed by the other interests. Especially is this true of the objective of security. The hopes for capital gain and for security seem to be substantially opposed, because to increase the value of one's principal requires an assumption of risk that is incompatible with a high degree of security. From the point of view of the aim of an expanding economy, this conflict is serious, for the interest in security is probably coming to be a more important controlling motive of investors. The increasing influence of security as a motive controlling investment does not, I think, reflect a change in the national psychology so much as it does the increased difficulties (largely taxes) of attaining the other objectives of investors. To the extent that the prospect of building a fortune or, more modestly, of augmenting one's capital declines, it is only natural that the objective of preserving that which one has will come to the fore. Reasonable as this may be from the individual point of view, it is clearly not conducive to the founding and expansion of new firms. For that social purpose, the prospect of appreciation of principal is the most important of the motives of investors.

*d) Protection of Purchasing Power.*—The objectives of investors mentioned have been envisaged in terms of dollars. Actually what the investor usually wants, especially to satisfy his desire for future income, is purchasing power. At times, the uncertainty of a future price level is so pronounced that a distinction between dollars and what they will buy is consciously made. When this distinction is made, it presumably gives a preference to ownership of tangible things and equities over money claims in periods of rising prices or when there is believed to be a prospect of rising prices; the preference is reversed in periods of declining prices. This reversal may suggest the possibility of stimulating risk taking investment by a rising price level; but to provide a continuous and secular trend of rising prices introduces so many questions of fiscal policy and repercussions on incentives in indirect and unpredictable ways that it appears to be an unpromising approach to the problems of encouraging expansion through private business incentives. This does not imply that the government has no responsibility in this matter;

it does have a responsibility for maintaining a stable price level, i.e., value of the dollar. Only when that is reasonably well done can the normal business incentives of investors and enterprisers function to best advantage.

*e) Desire for Security.*—The four positive desires that lead to investment are accompanied by certain negative desires, that is, desires that impede investment. These are the desire for security and the desire for liquidity.

Security can be considered as the relative assurance of gaining the contemplated rewards of investment or (a matter of degree) of the desire to avoid loss of principal. The investor can be encouraged by enhancing the possible reward or the chance of getting it, or by minimizing the possibility of loss of invested funds. Theoretically, there may be no important distinction; but in the investor's psychology, there seems to be a difference; and in trying to improve incentives for investors, there is a real difference. For example, the prospect of enhancing reward is affected by taxes levied on business incomes; by distinctions, for tax purposes, between capital gains and other forms of income; and by various devices for averaging income. The prospect of minimizing losses is affected by the treatment of losses. There is no way in which the tax system can ameliorate the impact of a negative over-all income except by extending (forward and backward) the effective tax period. The theoretical possibility of a subsidy to compensate for business failure would require that the government actually assume a joint responsibility with the private owners for starting and operating individual businesses. But we do allow capital losses to be set against capital gains (if any). This is an encouragement to an investor who contemplates the risking of a small amount of his funds in a particular venture; it is of no great aid to the outside investor or enterpriser who contemplates placing the bulk of his capital in a single venture. The principle of offsetting losses against gains might be extended by adopting the more liberal policy of allowing capital losses to be set against any kind of income.

These distinctions between the risk of income and the risk of loss of principal and their implications for policy raise the

questions of their relative strength and their application to the active enterpriser and outside investor. We do not have the answers to these questions. One impression is that the possibility of loss of principal is, relative to other considerations, very strong—perhaps stronger with the investor than the consideration of "more or less" of gains or the prospect of getting those gains. If this impression is correct, it suggests that the incentives for the outside investor would be best encouraged by greater tax allowances for losses. For the active enterpriser (owner-manager), it may well be that high prospective profits (after, as well as before, taxes) is a more potent consideration. Differences would also be expected between large and small investors, investors of different age groups, individuals, and institutional investors. On all these relations, we need more light.

The increasing role of life insurance companies, savings banks, annuity associations, and other repositories of funds in the direction of investments has a bearing upon the importance of the security motive, for such institutions must give primary attention to security and current income. Some of these organizations, however, are attempting to reconcile these objectives with that of enhanced values of the specific properties in which they invest. To emphasize this latter feature, of course, involves a degree of risk and speculation concerning the individual investments; but it is believed that these features can be kept within reasonable limits by diversification, spreading investments over a number of projects, careful study of the prospects, and managerial advice to the managers. Certain investment companies have been established in New England and elsewhere to provide funds for new enterprises or for soundly conceived expansion of small concerns. It is too early to say whether this type of relationship with the individual investor, who owns an interest in the investment company which engages in these activities, will come to play a more significant role in our economy. These investment companies however, do represent an interesting device by which conservative desires and needs of individuals may be reconciled with more daring and constructive investment in the expansion of industry.

*f) Desire for Liquidity.*—The maximum of liquidity would be attained by not investing at all or, speaking more precisely, by "investing" in gold or currency itself. The desire for liquidity apparently rests upon the individual's uncertainty about his own needs and upon the uncertainty of the relative earnings to be attained from alternative investments. It is the investor's desire to keep a free hand to move in any direction suggested by his own contingencies or by market developments. Thus a desire for liquidity will be enhanced by an impairment of the individual's sense of security and by any increased uncertainty as to the future of particular industries. From this latter point, it should be noted that the desire for liquidity might be stimulated whether the prospects of business *generally* appeared bad or good. Indeed, the expectation that new and bright investment opportunities may open up in the near future might induce investors to keep funds in liquid form in order that they may take advantage of such opportunities that arise or shift quickly into a new or promising field.

*g) Relation of These Desires to Bequeathing an Estate.*—In addition to these common incentives of investors, one might consider a number of specific purposes for savings and investments. These include a multitude of special objects, such as to accumulate sufficient funds to start a business or to educate the children, and so on. The desire to accumulate and preserve funds in order to leave an estate to one's heirs deserves special mention because it has some bearing on tax policies. In so far as this involves making provision for the needs of a widow or for a widow and children, in the event or earlier demise, it is commonly met by life insurance. In so far as "leaving an estate" means the passing-on of a fund large enough to be called a family fortune (that is, an estate which would be expected not only to care for the needs of one's dependents but also to be passed on to their descendents), my inquiries indicate that it does not really have much influence with young men. Except for a reasonable provision for their families, young men rarely make plans which run beyond their own lifetimes. Moreover, because this motive is satisfied by life insurance, investment of those funds is no problem for the individual saver. The channels of business into which

these funds will flow will be determined by the policies and requirements of the life insurance companies and other institutions. The effect of this incentive, therefore, in the earlier days of a man's earning career (particularly in the case of people who have not inherited substantial funds) is not, and will not be, to encourage the origin and expansion of business, unless some possible change develops in the investment policies of savings institutions.

The incentive to bequeath a large estate looms larger in the middle or later stages of the careers of men who have become wealthy as a result of other incentives. In the later stages of a career, when more conscious thought is given to the leaving of an estate, the motives of conservation of principal and the enhancement of it come into play and into conflict; and in this conflict, the desire to conserve what has been accumulated is likely to overcome the risk-taking desire for appreciation of principal.

If, in general, this view of changing incentives and objectives is correct, it would seem to follow that the desire to leave an estate would not prompt the risk-taking investments which contribute directly to the establishment and expansion of business. This would suggest that death taxes (inheritance and estate taxes) would have a relatively small effect on expansion—smaller, for example, than taxes either on the income of the business enterprise or on personal incomes or capital gains. The incentives approach to the problem, therefore, leads to the conclusion that death taxes can safely be considered primarily from the point of view of their effect upon the distribution of wealth and income and on the basis of equity or justice, without great fear that they will have as serious effects on the expansion of business as would several other alternative forms of taxes.

Also, if the above views are correct, the period of time during which the prospects of the future influence the individual investor's decision to venture his funds may be shorter than is sometimes assumed. The young or middle-aged man may well look forward to realizing his capital gains in a period of a few years; whereas the older investors, who are trying to conserve an established fortune not only for their own use but for

their heirs, may be influenced by a longer view. But since this latter group is more likely to seek the highest security, its attitude is less relevant to the expansion of business. This comment, of course, applies exclusively to individual investors. The business organization, if it is conceived as a separate entity, has a continuing life; and the viewpoint of its directors and managers may be a very long one. This long view, which the business itself can take, is affected by the prospects of the particular industry and by general economic and social stability; but it is not directly affected by the prospect of inheritance taxes. The organization may consider the possible death of an important owner or manager as a serious hazard; but the inheritance tax itself would only affect the distribution of ownership and not, in most cases, the continuation of the enterprise.

There are notable exceptions concerning all this. It seems to be generally true that older men of means are more conservative because they are directly influenced by a desire to leave an estate. But cases continually come to light at the time such men die which show a surprising number of very risky securities still being held. There are enough of these cases to raise a question whether such unusual conservatism, which does exist with older men of means, lies in the natural motivation of these men or in the tax system and avoidable uncertainties surrounding the venturing of funds.

In general, then, concerning the incentives of individual investors, it appears that the most significant ones from the point of view of encouraging the expansion of business are: the desire for appreciation of principal and the desire for future income. This conclusion is reached because the others will more likely lead into directions not so favorable to expansion. The desires for current income and security are best satisfied by investments in the equities of proved concerns and by the purchase of bonds. But the preference for seasoned securities and for lending, rather than for owning, capital can be reduced by policies which will either reduce the prospect of loss of principal in new and growing concerns or neutralize the effect of such losses by liberal tax allowances for them.

# 7

## *PROFITS AND RISK TAKING*

PREVIOUS chapters have indicated that, in so far as businessmen are controlled by economic calculation, the most obvious and important incentive is profits. In this chapter we shall discuss some aspects of profits and particularly their relation to risk and to differences in the skill with which the enterprise function is performed.

### TWO THEORIES OF PROFIT

Every type of economic enterprise involves commitment of effort and funds in the present for the sake of fruits to be yielded later. Because the future can never be completely known, a degree of uncertainty is necessarily involved. This would be true to some extent in any kind of society but it is particularly true in the environment of a free society; in such an environment, the fruits will be determined by the free action of consumers. There is always a question of whether the costs which are incurred now will be covered by the value of the products which will be produced later. The reward for engaging in such an enterprise is, therefore, uncertain. It is conceivable that all of the participants—workers, suppliers of resources, and managers—might share the burden of this uncertainty and would receive rewards or bear losses, depending upon the outcome of these ventures. In our society, however, this uncertainty of return bears particularly upon the enterpriser. To a large extent, the contributions of the other factors are rewarded in rather definite amounts, regardless of the outcome. There are important practical advantages in this division of function which are not necessary to enlarge upon at this point. The essential fact is that one of the characteristics of the economic reward to enterprise is its uncertainty.

This element of uncertainty is closely connected with the

subject of profits. There are two major lines of thought among economists concerning the nature and origin of profits. According to one view, they constitute a necessary reward for the assumption of risk. Risk arises out of uncertainty: it can be defined as the uncertain prospect of loss.

There are a number of contingencies which will, we know from past experience, beset any project which runs into the future. While we may know that they are present and while we may know something about the frequency of their occurrence, their actual occurrence for the particular individual may be quite unpredictable. Risk, therefore, arises or exists even though we may know with considerable precision what will happen in the future in a large number of cases. This is similar, for example, to the risk of human mortality; although the actuarial tables may give an accurate forecast of aggregates, there is still a high degree of uncertainty as to the length of life of any individual. With many of the risks of business, such as the risk of property damage from fire, our experience is sufficiently large and has been so carefully observed and measured that the aggregate property losses from fire can be reasonably well predicted. In such cases it is possible to employ the principle of insurance, under which the individual can substitute a certain present cost for the uncertain prospect of losses. But in many of the other risks of business—indeed, in most of them—this principle is not applicable; and the individual enterprise must bear the risk itself. The reason is that as to business ventures, generally, there is no basis for determining the odds accurately; and even if the odds are estimated in the purely statistical sense, such as is expressed in a mortality rate for grocery stores, the fact remains that the prospect of success or failure of a particular store depends chiefly on the qualities and policies of its proprietor and other special features that apply only to that store.

For rational men to make commitments in the present, the prospect of rewards must be high enough to cover the prospects of loss. It might appear from this statement that, if enterprisers forecast the future with reasonable accuracy, the profits of some would be balanced by the losses of others. But these forecasts of the future, even for the large number of ventures, cannot

be accurate; and even for the whole group of enterprisers in a particular line, an element of uncertainty remains as to the outcome. As we observed in our previous discussion of motivation, this uncertainty is one of the negative incentives or obstacles which must be overcome in order to induce the undertaking of ventures. Uncertainty, in the basic sense of a disutility, is a cost just as the tiresomeness of work is a cost of labor. This element of cost must be paid, therefore, by the mass of consumers of products—in the sense that the prices of goods generally, and in the long run, must be high enough to cover the costs and to provide a reward sufficient to induce enterprisers to assume this burden of risk. This is equivalent to saying that, in general and in the long run, the disutility of risk bearing will have a deterring effect upon the supply of goods; and the prices of goods must exceed the costs by enough to compensate for it. Since the excess is profit, this comes close to saying that profits are themselves a cost. Some economists present this line of reasoning as a partial explanation of the existence of profits. As one writer has put it, the question of whether profits are a "remuneration" for risk taking can be answered by asking ourselves whether society could get its goods produced at lower prices if there were no risks involved.[1] To that question, he says, there is only one possible answer—namely, the affirmative one.

The other view of profits is that they constitute a differential return resulting from the relatively greater efficiency (using the term in the broad sense of wisdom in making commitments and effectiveness in combining and managing the factors of production) shown by some individual enterprisers than shown by others. There is competition for continued existence among enterprisers; and prices must be high enough to cover the genuine costs of the least efficient enterprisers whose services are required by society. But other enterprisers, by their greater ability (or good fortune), are able to produce at lower costs than those of the marginal producers and, hence, lower than the price fixed "at the margin." For such capable or fortunate individuals, there will thus be something left over after paying costs; and this "something left over" is profits. In this view, then, profits are

[1] F. M. Taylor, *Principles of Economics* (9th ed.; New York), p. 497.

not themselves a cost. They do not enter into price. Rather, they result from price and from the fact that some producers can keep their costs below the prevailing price. They thus reflect the variations in the abilities and circumstances of enterprisers.

There seems to be no necessary contradiction between these views; rather, they seem to explain two elements or sources of profits. The view that profit is a necessary reward for risk bearing would indicate that successful businessmen in any particular line must, if we assume rationality on the part of enterprisers, make enough over their costs to offset the risk of losses from contingencies which are known to exist in the aggregate but the incidence of which is unknown as to particular individuals. This element of reward to the successful enterpriser might be regarded as the minimum necessary element of profits. As such various contingencies as natural physical hazards or variability of costs and prices are reduced, or as their frequency in the mass becomes better known through weather forecasting, business forecasting, and so on, this element of profit would presumably decline. The other element of profit arises from variation in abilities and would not be expected to decline (even if all enterprisers became more or less effective) so long as the differences between them remain as great as before.

## PROFITS AS A REWARD FOR RISK TAKING

The essential risks of enterprise (those that cannot be covered by insurance or other devices) must be balanced by the prospect of profits; and that prospect of profits must be sufficiently bright and attractive to induce enterprisers to accept the corresponding burden of risk. The profit prospect itself has several elements, as will be seen if we consider that a person might be induced to engage in a venture which promised almost certain success even if the prospective profits were small. On the other hand, he might be willing to engage in the venture even though the chance for success was small, providing the prospective rewards in the event of success were large enough.

The calculation of the profit prospect involves, at the minimum, a consideration of the "stake" which must be committed —money, time, effort and prestige. It also involves the estimated

chance of success and failure which we can call the "odds"; and it involves the "reward" to be secured in the event of success. The balancing of these elements by the businessman is analogous to the balancing of similar elements by a player in a game of chance. Since in the game of chance, these elements can often be well known in advance, it will be enlightening to follow through the reasoning in that type of activity. Such a game, in other words, provides a very simplified version of the problem that faces a business enterpriser; the three elements—stakes, odds, and rewards—are related in a very definite, indeed, in a mathematical way. For any given combination of stake and odds, there is a certain potential reward which will make reasonable the assumption of risk, for it will create a mathematical equivalence between reward on one side and odds and stake on the other. This can be simply illustrated by a gambling proposition. Two cards are laid face down on the table: one of them, if turned, will pay $10.00; the other, nothing. The value of such a chance is $5.00. If the cost of admission to this venture is also $5.00, a speculatively inclined person might accept this offer. It would be a rational decision because there is an equivalence of stake, odds, and rewards. The relationship can be stated more precisely as follows: The value of a *chance* to win a prize equals the value of the prize times the chance of winning it, the latter being measured by the estimated percentage of certainty. Thus, in the illustration: $5.00 = $10.00 × 50 per cent. Equivalence is attained when the stake is also $5.00. That is, a person is justified in staking $5.00 on a 50 per cent chance to win $10.00. But suppose that the possible reward is reduced—for example, by a tax of 50 per cent upon gains from such ventures. The taxable gain would be $5.00: gross reward ($10.00) less the cost ($5.00). The tax would be $2.50; and the reward or prize after tax deduction, $7.50. The proposal now in effect is a stake of $5.00 for a 50 per cent chance at winning $7.50. Since the value of such a chance is but $3.75, there obviously would be few takers of the offer.

If we are to induce reasonable men to undertake such ventures, the potential reward must be at least $10.00. (Among businessmen the reward would probably have to be somewhat

larger because of what Professor Irving Fisher has called the "coefficient of caution" arising from a dislike of uncertainty. On the other hand, gamblers do accept less than equivalence, counting the enjoyment of the game as part of their reward. If they did insist on actual equivalence, an honestly operated lottery could not show a profit. But for purposes of illustration, we have assumed that both players and businessmen will act upon "equivalent" rewards.) If we desire at any time to increase the number of venturers, we must increase the reward or improve the odds.

Now we can extend this illustration to a gambling room where various ventures are offered. The first venture offers a 9 out of 10 chance of success. The equivalent return in case of success would be $1.11 for each $1.00 risked, or 11 per cent possible profit. The proposal described in the previous paragraph offered a 5 out of 10 chance of success, a return of $10.00, and a possible profit of 100 per cent. We could have a whole series of such ventures, each with a percentage of profit that would provide equivalence of odds and rewards. What would be the effect of a limitation on possible profits? That would depend on the nature of the limitation. If it was stated that no profit could be over 50 per cent, the 5 out of 10 proposition would be ruled out completely; and the one which offered 9 out of 10 chances of success would not be affected at all. The effect of such a limitation—a ceiling on profits—is to rule out the risky ventures and restrict the play to the relatively safe ones. On the other hand, if the limitation reduced all profits by a proportionate tax on all gains, then none of the ventures would yield equivalence. This kind of tax would not, as some writers have assumed, favor the safer projects at the expense of the risky ones. Play would tend to come to a stop at all the tables (or all ventures) until the rewards (before taxes) were raised enough to offset the tax. Indeed, the players would be reduced to those who did not know the facts, those who were willing to take uncalulated risks and those who regarded the game itself as its own reward.

If we pursue our illustration of the game of chance a bit further and bear in mind the analogy between it and the assumption of risks by business enterprisers, we can draw certain con-

clusions as to the significance of each of the elements in the profit prospect. Suppose that we wish to encourage the drilling of oil wells in new areas. Let us ask ourselves what the effect would be upon the supply of enterprise if we changed any of the elements of the profit prospect, leaving the other elements unchanged. First, what would be the effect of reducing the risk? This risk reduction might be brought about, for example, by an extension of our knowledge of geology and the indications of the presence or absence of oil. It is quite clear that such an increase in information would tend to improve the odds of success and reduce the chances of loss. It is evident that if this were done and if the potential reward and other elements remained the same, there would be an increase in oil-well drilling. Second, what would be the effect of reducing the necessary stake? The stake might be reduced by improving the technique of drilling and thereby reducing the amount of funds to be committed to the project. It is evident again that if this could be done and if the other factors of the problem remained constant, there would be an increased supply of enterprise in this field. Third, what would be the effect of increasing or reducing the reward in the event of success? Such a change in reward could well be caused by an increased or decreased price of oil or by increased or decreased taxes on the income derived from successful ventures. The answer again seems clear that the effect of increasing the reward would be to stimulate activity, and that the effect of reducing the reward would be to discourage activity. Fourth, what would be the effect of reducing the possibility of loss? Such a change might be made, for example, by tax refunds on losses incurred in this industry. If the odds, the investment, and the prospect of reward in the event of success all remained the same, it is clear that to reduce the amount of loss in the event of failure would have a stimulating effect. The government can do something to stimulate the supply of enterprise by permitting the losses of some ventures to be offset against the gains of others. But in a free enterprise society, it would be very questionable for the government to undertake to share genuine net losses; for in order to do so, the government would have to assume some degree of responsibility for the undertaking of the venture in the first place.

These four variations indicate that the term "improving the profit prospect" has several aspects. It does not mean merely the increasing of the amount of profits to the successful firms, but it encompasses all the factors in the equation. It also suggests that, if the supply of enterprise it to be maintained at a desired level, any adverse change in one or more of these elements must be balanced by correspondingly favorable changes in the others.

This is, of course, an oversimplified illustration, for in business ventures there is a whole scale of possibilities instead of only two. There is usually a slight possibility that a reward may be very high; a somewhat greater possibility that the reward may be moderate; perhaps an equal possibility that there will be a minor loss; and a small possibility that there will be a total loss. Some such scale, with an infinite number of variations, represents the possibilities facing anyone who supplies funds on an equity basis in a normal business venture. The fact remains, however, as in our simple illustration, that the composite or average of these possibilities must appear reasonable.

The business venture differs from the game of chance, not only in the fact that there is a greater range of odds and rewards, but in the fact that these odds and the corresponding rewards are themselves surrounded with more or less uncertainty. There is uncertainty in the stake itself, for unforeseen costs and difficulties may arise which will require the investment of more funds and efforts than had been originally anticipated. The odds are unknown in spite of statistical records that may be available of past experiences. For example, the statistics of business mortality do not give a very satisfactory answer to the prospects of success for a particular individual in a particular environment. Also, the rewards to be attained in the event of success are more or less uncertain. Moreover, the nature of the uncertainty in a business venture is different from that in games of pure chance. In business decisions, one must take into account, not only the objective factors, such as costs and the market demand for the goods being produced, but also the probable reactions of other businessmen to these facts and prospects. For example, if it is generally believed, on apparently good evidence, that the demand for a certain type of plastic material

is going to be active and if the costs of production are known, it does not follow that the profit prospect is good; for if the same conclusion is reached by many other manufacturers, the future supply of the product may be so large as to depress price to a non-profit level. The game of poker bears a closer relation to business because success in the game depends on the ability to combine a knowledge of the odds with a judgment of the psychology of the other players and their reactions to the odds.[2]

This difference in the nature of uncertainty further suggests that in the game of pure chance there is no risk as to the aggregate outcome. Hence, if you bought all the tickets in a lottery, you would know in advance what the cost and return would be. (This would be equally true, of course, if you bought a one-tenth share in each ticket.) But you would still have considerable risk if you bought an equal share of every grocery store started in the United States this year or if you bought one share of every security in the stock exchange. In short, business risks in a free enterprise system arise both from factors in and affecting the individual firm and from others that affect a whole industry or the whole economy. For example, in our system an automobile manufacturer faces the uncertainties of total demand, other factors affecting the industry, and, in addition, the special factors affecting his own company, such as his own and competitors' success in designing a car which will meet public approval.

The odds and the rewards in business affairs cannot be so definitely known as they may be, for example, in a game of chance; and this means that businessmen's judgments of them will be influenced by their own attitudes and mental states. In other words, the evaluation will be subjective, to a greater or less extent. Consequently, some businessmen will differ from others in appraising these elements. A high degree of optimism and courage will lead to a more favorable judgment of these elements of the profit prospect; and a deeply grounded conservatism or pessimism and a lack of daring will lead to a less favor-

[2] A classic and highly technical treatment of this subject is found in the book *Theory of Games and Economic Behavior* by John von Neuman and Oskar Morgenstern (rev. ed.; Princeton: Princeton University Press, 1947), *passim*. A short and useful discussion which draws upon the larger study is that by John McDonald, "Poker: An American Game," *Fortune*, March, 1948.

able judgment, even though the tangible evidence is the same in both cases. The fact that the future is never completely known provides, therefore, the basis for variation in reactions among individuals and, in a sense, a genuine freedom of choice. If the outcome of ventures were completely known, then rational men, controlled purely by economic calculation, could have little basis for differing as to the propriety of the venture.

Since the appraisal of the elements of the profit prospect is, to some extent, subjective and dependent upon the state of mind of the individual businessman, it is important to recognize that this state of mind and degree of optimism and courage are highly contagious. The actions and sentiments of some enterprisers have an important effect upon the others. Moreover, these intangible factors are affected by the environment in which decisions are made and they, as well as the more tangible factors, can be influenced by public and social policy.

Before leaving this subject of risk in its relation to profits, we must recognize that it is not merely a problem of the commitment of funds. An enterpriser, as distinguished from the silent investor, is committing his time and efforts, as well as his funds, to an exacting job. The decision to start a business will ordinarily affect the enterpriser's way of life, the place of residence for himself and family, his freedom of action, his reputation as a businessman, and his prestige as a substantial and wise member of the community. Risk involves all of these, not merely the bank account.

Moreover, in large business organizations, many of the decisions involving expansion are made not by the owners but by hired men whose direct compensation is in the form of wages or salaries rather than in profits. Some writers have made much of this distinction. For example, it has been said that in the modern corporation the stockholders bear the final burden of the game while the zest of the play is enjoyed by the business managers.[3]

It seems generally closer to the facts to say that the effect of a

[3] A. S. Dewing, *Financial Policies of Corporations* (4th ed.; New York: Ronald Press, 1941), p. 856. Also Joseph A. Schumpeter, *Theory of Economic Development*, p. 75 n. Both authors appear to think of risk only as the possible loss of capital and, hence, naturally and exclusively borne by capitalists. This is contrary to the view expressed here.

particular business decision commonly means much more to the responsible manager than to a stockholder—even a large one. Suppose that the sales manager of one of the divisions of a multiline automobile company sponsors a plan for distribution of one of the cars of that corporation. Upon his sponsorship the plan is approved, and under his direction it is put into effect. If it succeeds, the profits of the corporation and possibly the dividends may be increased by 5 per cent. But the sales manager's reward may be a doubled salary (and this may well constitute his entire income) and enhanced prestige, both within and outside the company. If the plan fails, earnings might be reduced by 5 per cent, but the manager may lose his job; and his chance of equally profitable employment elsewhere will not be helped by a conspicuous failure. Not even the largest stockholder of the company will be so seriously affected one way or the other. The balancing of risks and rewards in terms of costs and values, therefore, characterizes the decisions not only of those who receive profits in the strict sense of the term but also of the hired managers as well.

This aspect of profits (a reward for risk taking) deserves particular attention in a dynamic economy because progress implies change, change implies uncertainty, and uncertainty implies risk. Risk bearing is thus peculiarly associated with business expansion because in a static situation uncertainty could be reduced to a minimum. But if we wish to take advantage of new technological knowledge and to exploit new resources and new levels of markets, we are bound to have a substantial amount of uncertainty; and perhaps the greatest problem of stimulating expansion is to induce individuals to accept the associated risk. It is true that some progress can be made in reducing risk without checking progress. Better means of business forecasting, better analysis of markets and consumer desires, and better knowledge of economic forces will provide us with a better basis for prediction; and we can well hope for progress in these directions. Nevertheless, the limit of our ability to foresee the future is easily reached. Research can carry us to a certain point, at that point business judgment must take over—and that means a nonscientific weighing of future prospects.

## PROFITS AS A DIFFERENTIAL

The other explanation of the existence of business profits is in the relative superiority of some enterprisers over others. This element of profit is essential for providing incentives to businessmen who have already made the commitment to enter into a particular enterprise. The influence of profits as a reward for risk taking would presumably be greater upon the potential enterprisers and would influence their number, thereby affecting the supply and thus the price or reward of enterprise.

In its extreme form the differential explanation of profits implies that there are normally some firms whose costs are high relative to the others. If the demand of the market is such as to require the services of those high-cost firms, the price must be high enough to cover their costs. Then the others who can produce the same products at a lower cost, but who can nevertheless get the price set by the costs of the less efficient ones, will secure a margin between price and cost, which is profit.

In the case of producers of staple standardized products, that view of the origin of profits seems fairly realistic. In other cases it seems that it assigns too great significance to the marginal firm. Rather, it often appears that, the firms which exert greatest influence upon price are those which are fairly effective and which are making profits, and that the less effective ones show no profits because their costs are higher or because their product or service or selling methods are inferior to those of the profit-making companies. But whether or not the theory be accepted in its simplest form, it does appear that relative effectiveness is very significant in determining profits in any competitive industry. The profitable firm almost invariably has some superiority over the general run of its competitors—be it in lower cost of production or of distribution, a superior product or package, more acceptable "service" and distribution, or in some other respect or a combination of these. If all, or practically all, companies could attain these same standards of excellence and if competition prevailed, real profits would tend to shrink or to disappear. It thus is true that profits arise from differences in the effectiveness of competitors.

It is true that there are times when virtually all firms will yield a profit and other times when none of them may do so. This apparent contradiction of the differential theory is explained on the ground that the theory in its extreme form assumes a high degree of mobility of firms—that is, as the price declines, the less effective ones will drop out, and as the price rises, new ones will always come into existence. But with industries, generally, this condition of perfect mobility is never attained. Therefore, if demand increases quickly, the supply of additional firms (or increased supply by existing firms) will not take place immediately; and the result may be that virtually all firms will show profits. On the other hand, if the demand shrinks rapidly, it will be quite impossible to close existing enterprises and, in many cases, not feasible to reduce production of existing ones quickly enough to adjust supply to the new demand situation; in that case, even the most effective firms may show losses. But while the pure theory, based upon the artificially simple assumption of perfect mobility, does not serve as the day-by-day explanation of the existence of profits, it does exert its force in the long run. In the course of time, there *is* a high degree of mobility of enterprise, i.e., if the demand continues to be large, there will be a strong tendency for the number of firms and for the output of the existing firms to increase—and in the long run, firms cannot continue to contribute to the supply if their costs are not being covered. The differential theory, over a period of time, therefore, provides perhaps the most important explanation of the existence of profits in a competitive society.

This element of profits arises, not from the absolute level of ability of business enterprisers as a class, but from the variations in ability among those enterprisers. We cannot expect that any improvement in the average level of ability of businessmen would cause profits to increase, although an increased variation in ability might be expected to do so. This differential profit would continue to exist as long as some businessmen are more capable and farsighted than others. There is no prospect that this variation in ability will decline, although there are many ways in which the opportunity to use ingenuity and abilities might be limited. Any of the laws or regulations, such as

discriminatory laws against chain stores or fixing a minimum markup, would presumably tend to reduce business management to a dead level; and, in so far as regulations do this, they would tend to reduce profits. But there is no reason to expect that the variations which nature provides are likely to be eliminated or reduced.

The importance of this differential element of profits points a moral to businessmen and especially to young businessmen—namely, that profits are to be made not merely by being good but by being better than your competitor. The analogy of the race or competitive game illustrates this point. A concern may discover a new product, a new way of making things, or a new principle of management; or it may merely use existing methods more effectively and thereby lift itself above the level of its competition and make profits. But if this concern rests on its oars, it will find that other companies will have copied these improvements; and when most of the competitors have done so, the improvement will cease to be profit yielding. The conclusion evidently is that continuous profits can only be made, assuming effective competition, by continued progress. There are some organizations which, even in highly competitive industries, do make profits year after year by continually recognizing that what was good last year will not be good enough this year or a year hence. The differential element of profits then, while it is a "surplus" and not a necessary reward for costs and, in the minds of some people, less defensible for those reasons, is really the strongest incentive to continuous progress. It is very doubtful if any system of paying a reasonable wage to people for performing the enterprise and management function could be so effective as this prospect of prizes whose continuance depends upon continued superiority.

## THE NATURE OF PROFITS

If we turn now to the question of what profits really are, instead of merely trying to define them by their origin, we can say that profits represent the difference between costs and values. This is the way the businessman thinks of them, although in his accounting procedures, there may be questions as to precisely what should be included in the term "costs." A moment's

reflection will show that this statement could be put in another way which would recognize that costs themselves are values, as indeed they are. The labor which is employed, the raw materials which are used, and the part of the life of a machine which is expended in the production of a product—all of these have values. We can say, therefore, that profits represent the difference between the values which are used up in the production of the product and the value of the finished product.

It may be asked why there should be anything left over, that is, why the value of the finished product and its price should not be equal to the sum of the costs. The answer can be in terms of either of the two theories of profits. In terms of the differential theory, it would be that, in the case of some producers of standard products, the costs and the value of the end product may indeed be the same. But others can produce identical products at lower costs, and hence they will secure a profit. Or among producers of competing products, some can produce a better product than others at the same cost and in this way produce this surplus of value. In terms of the risk theory of profits, the answer is that the price must be high enough to make the production attractive to the enterpriser. This means that it not only must cover his costs in the sense of predictable expenses but must also yield a compensation for the assumption of risk. We are justified in adding this factor to the costs because uncertainty is itself a negative incentive.

A distinction must be made between profits in the aggregate, for example, profits regarded as a share of national income, and profits as they appear to individual firms. The risk theory of profits seems to indicate that under competitive conditions a normal price is one which provides profits to the successful ventures equal to the losses of the unsuccessful ones, plus or minus a margin to cover the venturers' likes or dislikes for uncertainty. For that reason, the risk theory of profits is not so convincing as the differential theory as an explanation of profits in the aggregate.

## PROFITS IN PROSPECT

For their effect upon the functioning of our economic system, profits can be regarded in two other aspects: first, the pros-

pect of profits; and second, the fact of profits. As to the first, it is clear that all business involves making plans for the future, and this inevitably involves the risking of something for the prospect of gain. There must be a prognostication of consumer desires, of possible volume of production and sale, and of prices and costs. As these factors bear upon profits, they contribute to the "profit prospect." If that prospect is sufficiently good to warrant the assumption of the risk which is entailed, business activities involving the building of plant, production of goods, purchase of materials, and the hiring of men will take place.

The prospect of profits acts not only to stimulate action but to direct such action into particular channels. From the point of view of any society, the desire should be to produce those things which will be worth more than they cost, using the terms "cost" and "production" in a broad sense. In a private enterprise system the best indication of what things are worth is what people are willing to pay for them. This excess of price over cost is profit. Individuals, staking their funds and efforts in a search for opportunities to produce those things which will yield the greatest profits tend, therefore, toward those things which are most "profitable" for society to produce.

With some kinds of goods and services, the state or other large groups of organized society makes this choice of direction of production consciously. For example, in the development of parks, the building of libraries, the conservation of natural resources, and the provision of means of education, we must pass more or less deliberate judgment through our representatives on what the thing or service is worth by some accepted standard of value and on how much it will cost. At least, we should do so if we are to manage our affairs sensibly. Such decisions are at best extremely difficult, even for those services whose social values would not be seriously questioned. It would surely be much more difficult to pass judgment on the relative values and costs of the thousands of day-to-day services and products desired by millions of people having a high standard of living and, hence, a desire for a great variety of such things. In our economic system we disperse the authority for making such decisions among the thousands of enterprisers and give them as their

guide the maximizing of values over costs, that is, the value of end products over the value of the goods and services used in producing them. Thereby we solve the problem in at least a tolerable way.

Inevitably, these decisions will not satisfy everyone. There will always be those who feel that they know what is best for the community, who will, for example, prefer good books to trashy literature, both for themselves and for others; these people will be dissatisfied with the results that are yielded by this free system of choices and incentives. But theirs is an undemocratic belief in the ability of some to decide for others what is best for them. There are times when the judgment of leaders must be accepted—for example, in the prosecution of a war or in the preservation of the health of a community. But among a free people, the area in which the decisions are determined by the free choice of individuals should presumably be maximized; and the profit system yields that result better than any other system which has been discovered.

Moreover, any society which is managing its affairs wisely will strive to reduce the costs of the things which it desires. Here again, the prospect of profits leads free individuals to strive toward that socially desired end. Since profits are the difference between cost and value, they can be enhanced not only by production of those things which have high value but by efforts to reduce the costs of producing them. The justification, then, for the future prospect of profits is threefold: first, it provides the driving force for action; second, it directs that action to the production of things which will show the greatest excess of value over costs; and third, it provides the stimulus for seeking the most efficient and low-cost methods of providing those goods and services.

## PROFITS IN FACT

The prospect of profits and the fact of profits are, of course, related; no amount of optimism that might lead to a hope for profits can continue year after year if the profits do not actually materialize; and, conversely, the existence of profits at the moment does stimulate the hope for profits in the future. That is

one reason why business enterprise is active at a time when profits are good and, conversely, it is difficult to convince businessmen that the future is bright when the present is dark. "Profitless prosperity" is anomalous and usually short. The effect of this relation between the present scene and future prospects has an important bearing upon the excess of optimism which marks a business boom and the continuation of a low level of activity at the other extreme of the business cycle.

The fact of profits has another effect upon the supply of enterprise, namely, that profits supply the means of expansion. They largely provide the wherewithal (the sinews of war); and where they do not serve that function directly, they provide a basis for obtaining those necessary resources.

A good flow of profits enables a firm to expand its activities. It enables it to do more than a bare minimum by way of salaries, wages, and the meeting of other operating costs. It also provides the capital funds for expansion. This method of providing capital funds has attracted considerable attention in recent years. There are those who believe that it has become an increasingly important source of funds. Whether that is true or whether this source is only recently receiving its due attention is hard to determine; but in any event, a good flow of profits is the chief source of capital in some segments in American industry today. This is particularly true of American manufacturing industries. The classic example of the Ford Motor Company, into which a mere $26,000 was invested from the outside, has been mentioned. The remainder of the capital of that huge concern represents the plowing-back of earnings of the company.

The earlier treatments of economics seem to imply that capital for the establishment and development of companies would come primarily from an outside group of investors. That seems to be true of the railroads, the public utilities, and some branches of manufacturing; but for most of manufacturing, retail and wholesale business, the distinction in function between investors and the enterprise has tended to break down; in fact, the enterprise in these lines supplies its funds very largely from its own profits. It is, in a sense, its chief investor.

This service of profits is particularly notable in the case of

small businesses. The typical situation seems to be that the original stake is provided by the enterpriser himself from his previous savings or by his relatives and friends. As the business prospers, the enterpriser draws out only a part of the earnings for his own use; the remainder of the earnings provides the working capital or the plant and equipment for the expansion of the business. This pattern is likely to be followed until the concern has grown so big "on its own fat" that it would no longer be considered small business, and it can then more readily go to the capital markets for its required equity funds. Indeed, one basis for the line of demarcation between small business and large business is the point where the business can effectively draw upon the open capital market for funds provided on an impersonal basis.

Even in those cases where additional funds are to be brought into the business from the outside, either from individuals selected on a more or less personal basis or from the general capital market, the past accumulation of capital out of the earnings of the company acts as a spearhead for raising more funds, for the existence of considerable capital encourages new equity investment.

Examples of this usefulness of profits can be found in almost any successful enterprise. The origin of a particular concern, which now employs some two thousand workers, goes back to the early days of this century when a young man out of college combined forces with another who had an idea. The young enterpriser had $400 of his own savings; a brother supplied an additional $1,000; and other friends and relatives provided enough more money to make a total of $4,000. In the early years of the company, the earnings were very largely plowed back. After a few years, when the concern had some $40,000 of capital, an outside investor approached the young men with an offer of additional equity funds to the extent of some $8,000. With this single exception and current bank financing, the concern grew to substantially its present size before ever soliciting funds from the outside. This company, like so many others, owed its inception to the prospect of profits. It owed its substantial growth to the fact of profits. A general

appreciation of the fact that profits are not merely a source of income for individuals but that they are the mainspring for expansion and very largely the means of expansion is necessary if our public policy, dictated as it presumably will be by the prevailing views and prejudices of the people, is to be directed toward the creation of more jobs and more goods.

## RELATION OF PROFITS AND PRICE

Because of the divergent views on the nature and causes of profits, not only among laymen but among economists as well, it is not surprising that popular conceptions of the relation of profits and prices are confused. Do high profits cause high prices? In the postwar period, for example, the country was beset by high and everrising prices. These were accompanied by large profits of business. Did the high profits cause the high prices, or did the high prices cause the high profits? Or was the relationship purely coincidental? If we consider the question on the assumption of reasonably free market forces, the answer seems to be that the high profits resulted from a combination of factors influencing the demand and supply of goods. On one hand, a large supply of purchasing power was available in the community which people seemed eager to utilize—partly, no doubt, because of their backed-up demand for many goods created when production was restricted during the war. On the other hand, the productive resources of the country were insufficient to produce a supply of goods which would satisfy that demand *at the existing prices*. The qualification as to existing prices is important, for it is a basic principle that in a free market there is strong pressure for the number of units supplied to be equated to the number of units demanded at a price. The function of price is to so regulate the amount demanded and the amount supplied as to bring about this equality. In view of the postwar demand-supply situation, the natural way for prices to perform that function was for them to rise, as indeed they did. Unit costs did not rise so rapidly because, in some cases, the prices of cost elements (labor, materials, and others) did not advance so rapidly as the prices of finished goods. In other cases, the very large volume of production made it possible to attain such wide

utilization of plant and labor that, despite rising wages and material costs, the advance in unit costs could be held in check. An unusually large disparity arose between costs and receipts because of such forces, and that margin yielded the "something left over," which is profits. To the extent that this picture is correct—and it is believed to be a reasonable description of a large part of our economy—it is clear that postwar profits resulted from the cost-price relationship and were not themselves a cause of the high prices.

To this analysis, it may be objected that if a seller chose to accept lower prices, taking the difference out of profits, he surely could have done so. Even that, however, is not certain. There were a number of sellers in that period who deliberately attempted to do precisely that. For example, the steel and the automobile companies attempted to maintain prices lower than the free forces of the market would have established. The result in many cases was that the goods passed from the original buyers to others at the higher prices which the original sellers were trying to avoid. The profit, thus, did not disappear: it was merely realized by those who were fortunate or clever enough to operate on the margin between the "administered" prices and those that the market made possible. If it were possible to prevent these practices (gray markets and black markets), it could be argued that the fortunate buyers (and this could not include all potential buyers) would themselves realize a profit in the sense that they would be securing a product at less than its true market value. In short, the profit existed under competitive conditions because of the difference between cost and value; and the only question was who was going to get it.

The above description, however, applies to a reasonably free and competitive market; and it requires modification when and to the extent that those conditions do not exist. In the field of public utility rates, for example, profits are regarded by the public utility commissions or other rate-making authorities as almost in the category of costs, for the reasoning is that a rate should be permitted which covers costs and yields a reasonable return to the enterprisers. In this case, the definition of "reasonable" surely does affect price; and it would not be proper

to describe profit as the "something left over," for it was one of the determinants of price itself.

Moreover, in many cases, businessmen as well as their critics think of profits differently from the way we have described them; this is revealed by their frequent statements that their prices are based upon costs *plus* a reasonable profit. In so far as that is their intention and in so far as they can in fact carry it out, profits would seem to become a determinant of price. Frequently, however, these statements of businessmen should not be taken too seriously; or at least they should be taken as an expression of a hope rather than of an actuality. The effort to carry out such a policy, however, may result in maintaining higher prices than would have been set by free market forces, whether they do in fact yield the desired profit or not. This situation is especially to be found in a period of depression and in those industries in which there is a considerable rigidity of prices.

To summarize in a single statement the relation of profits to price in all these different parts of the economy is obviously not possible; but it does appear that profits have peculiar features which distinguish them from wages or other cost elements and that, generally speaking, they result from cost-price relations rather than cause them.

## HOW HIGH SHOULD PROFITS BE?

The general average or level of profits may be high at some times and low at others. Also the level of profits can be affected by taxes levied upon them specifically (as distinguished from taxes on any and all forms of income). With these possibilities in mind, it is possible to inquire whether a high or low level of profits is more socially desirable. On this question it appears for the competitive sector of our economy that if our economic system is properly functioning, the larger the profits are, the better. By the "proper functioning of the system" is meant plenty of opportunity for newcomers to enter the field, competition between those who are in the field, and no fraud or misrepresentation in the sale of goods or exploitation of weak sellers or buyers. Under these conditions, high profits will serve the community well. For the higher profits are, the more enterprise will be

forthcoming, the greater will be the tendency to supply the needed goods and services, and the greater will be the supply of funds with which enterprisers can work.

It might be argued that profits in the sense of a differential between values and costs should be large, but that there still is justification for taxing away any profits which by some standard or another are regarded as excessive. In other words, the difference between cost and value does measure the value of an activity to society; but this does not tell us who should be allowed to enjoy the benefits of that differential. But it should be recognized that profits serve the functions which have been outlined above only in so far as they remain in the hands of enterprisers or can be expected to remain there. In reaching this conclusion we are bearing in mind that the difference may be negative; that is, the costs may exceed the values of the products. In either case the profits or the losses should impinge upon the enterprise as long as it is responsible for its own actions.

It may also be objected that we do at times recognize the concept of excess or excessive profits. That is true, and it is appropriate that we recognize these concepts under certain circumstances. First there is the situation wherein one of the necessary conditions of the generalization, freedom of entry or effective competition, is not present. This exception is particularly pertinent in the case of public utilities in which it is recognized that we cannot, in the interest of efficiency, have several suppliers operating in the same market. In that case, we cannot have competition (at least not full-fledged competition); and accordingly we must set up some limits upon profits which are to be permitted. This we do through regulation aimed at adjusting rates to costs.

Another instance occurs during time of war, when it becomes necessary for the community to insist that its need for goods and services required for the national safety shall override the preferences of individual consumers and producers. In short, we cannot then permit a full functioning of a free economy. Since the services which high profits would normally render under those circumstances are neither necessary nor desirable, we are justified in abandoning the concept of freely determined profits. Such a

period is characterized by a shortage of materials and services rather than by any need to expand the economy. The motives which dominate a society and the conditions for attaining them in wartime are almost diametrically different from those of peacetime. The concept of excess profits and the heavy taxation of them is, therefore, well justified in wartime, but it would be a serious mistake to carry that concept and that form of taxation over into peacetime.

But, in spite of our defense of high profits, it must also be said that under a competitive system the profits to be obtained by the performance of any single service in a particular way should and normally will decline with the passage of time. Profits resulting from doing any one thing in one way are constantly subject to erosion by the forces of competition as well as by the increasing supply of those goods and services which creates the necessity of offering them at lower and lower prices. This is the normal course of things, and it is well that it should be so.

On the other hand, new products are continually being offered on the market which will secure higher rewards at the outset. Also, new methods are or should be devised which will reduce costs at the outset. Since they give the persons responsible for them an advantage over other firms, they also will yield high profits at the outset. The new methods, however, are copied, and thus a new floor of costs toward which prices again start to move is established. We have, then, in a healthy economy at any moment a whole series of business activities, each activity in its existing form tending toward lower profit returns. But if there are enough activities in the early stages of this devolution, the average rate of profits of industry as a whole and the absolute amount of profits will be sustained.

This concept of declining rates, combined with stable or even rising averages and totals, applies not only to the society as a whole but to individual firms. There is no reason why an individual enterprise ever needs to grow old in the sense that an organism does. Such an enterprise can be viewed as having a whole series of activities. A new thing or a new method is devised, yielding profits, which gradually decline; but if the enterprise is alert and progressive, the place of that activity will

promptly be taken by another—and thus the rate of profits of the concern may remain at a high level. In a well-functioning society, then, profits should be the reward not merely for doing a thing well but for doing it better than competitors. If the conditions of free entry, maintenance of competition, and prevention of fraud and exploitation are combined with uncontrolled profits, we can and should expect a continual decline in profits in the one sense, combined with a maintenance of their total in the other; just as we can expect that in a rapidly growing population, although every individual is growing older, the average age of the population may be becoming younger. The analogy also suggests the reverse situation, namely, that when the enterprise or the whole economy ceases to advance through new products and new methods, the average rate and the total amount of profits would be expected to decline. The moral for business is clear.

Moreover, to say that in a competitive system high profits serve the community well should not imply that profits to all should be high. The proposition can only apply to the general level of profits. Such a level or average will and should be made up of widely varying individual profits. With the turn of the wheel of fortune and with the differences in abilities and wisdom of enterprisers, some will win and some will lose. A healthy situation will be one in which a considerable number of the venturers do win prizes and in which some of those prizes are liberal; but there must always be the possibility of no reward and of net loss in order to impose upon enterprisers the necessity of careful judgment in determining the activities in which to engage, and also to impose upon them the necessity of keeping costs at as low levels as possible. It is and should be a *profit and loss* system. The community would be badly served by a flat level of profits, even though it were moderately high. It will be well served by a high average of profits made up of a composite of losses, moderate profits, and high profits.

## DIFFERENCES BETWEEN PROFITS AND OTHER SHARES OF DISTRIBUTION

The first important difference between profits and compensation for services in the form of salaries or wages is in the

greater uncertainty attached to the former. Payment for employed service is a contractual obligation, and those payments constitute by law the first claims upon the product and upon the enterprise itself. Profits, on the other hand, are what is left after all claims have been satisfied. Prospective profits should, therefore, be higher than prospective wages for people of comparable abilities and for comparable efforts, if we are to induce an adequate number to choose the role of enterprisers and employers. (This, of course, refers to incomes of individuals and not to shares of the national income.)

A second important difference is that profits have a more direct effect on the supply of enterprise than wages or salaries have in the supply of services. The reason for this distinction is in the alternatives which are open to business enterprisers and to the sellers of personal services. The sellers of services are dealing in the most perishable of all commodities. The labor which is not sold today is forever lost. For that reason, a person selling his services will ordinarily accept the best offer available at the time. The venturer of funds, however, can and will refuse to go into a possible venture unless, judged by the odds and rewards, it "makes sense." His funds can be withheld from use temporarily or even permanently. His alternatives are, therefore, to invest or to hold his funds in liquid form. Consequently, the supply of labor or other personal services will not be very greatly affected by the reward (the reward serves chiefly to direct those services into one line or another). But the supply of capital ventured in business projects to hire men and to buy materials, equipment, and plants in the hope of selling their products at a profit will be very definitely affected by the prospective reward. As to this form of income, even more than to others, we should, therefore, be guided primarily by the broadest considerations of social expediency, rather than by vague concepts of justice or "fair price."

## PUBLIC ATTITUDES TOWARD PROFITS

There has been some evidence in this country in recent years that a change has come about in the attitude of the general public toward the propriety of profits, and especially of large

profits, which runs counter to the views just expressed. Can that trend be reversed? In the opinions of some observers, that is the most serious question for the preservation of free enterprise. In that view our system is endangered more by a loss of faith in the social functions of profits and in the profit system and by the resulting political and social limitations imposed upon it than it is by economic developments, such as a lack of investment opportunities, tendencies to oversave, and other aspects of the mature economy concept. Indeed, no one can feel sure that these intangible and ideological trends may not so corrode the economic machine as to make it ineffective and to force its scrapping and change to a quite different model.

The hope of gaining the support, or at last the acquiescence, of public opinion for a healthy level of profits depends upon education, improved information, and the development of a high degree of self-restraint. Let us emphasize briefly the need for each of these.

The education is needed to give to the general public an understanding of basic economic principles and the initiating role of enterprisers in a private economy system. Such an understanding would lead to a more general recognition of the fact that any factor of production—labor, capital, or enterprise—is benefited by an increased supply of the other factors. In the case of enterprisers, this general proposition is particularly true, for they serve as the activating factor to bring together and make productive all the others. Specifically, the moral for labor is obvious: profitable business and a high level of business activity are the only bases for a high level of real wages and a plentiful supply of jobs.

It should also be recognized that profits actually do accompany high wages, full employment, and abundant goods. They do not dip deeply into social income when that income is small. In a time of prosperity, business profits will be large, both in absolute terms and in rates of profits; but in periods of depression, they shrink even more than do the other shares in distribution. Bondholders, landlords, and wage earners, although they may suffer in reduced incomes, maintain their shares better than do the receivers of dividends and other business profits. The

rewards of enterprise can only be gained from a degree of prosperity which is bound to benefit all groups; they do not act as a drain upon the social income at times when that income is generally inadequate.

Although this necessary understanding is only of the most elementary nature, its widespread attainment is a big order. But it must be met. During the nineteenth century a general understanding of the social function of profits was not essential. The system worked without very definite effort to control it or even, except for a few economists, to understand it. But for various reasons, we have become self-conscious about our economic body and interested in controlling it. That change of attitude may be desirable and, in any event, inevitable; but it can be disastrous if our efforts are based on fallacious ideas of the nature of the organism to which we are giving conscious consideration.

The information is needed because there is a very widespread misconception of the magnitude of business profits. Various public opinion surveys have asked people generally (not shareholders only) what they regard as a reasonable rate of profit, as a percentage of sales. A common answer has been: "About 10 per cent." To the question of whether they believed most corporations were making (1946–47) unreasonably high profits, many have said: "Yes." But the fact was that the net profit margins in cents per sales dollar of *leading* manufacturing and trade corporations after taxes were, in those years, for the former group 6, per cent in 1946 and 7.1 in 1947, and for the latter group, 4.5 per cent and 3.7 per cent.[4] Rates of profits vary widely between companies, between industries, and between years; and they can be computed as proportions of the sales dollar or as returns upon the investment and with other variations. But by any standard, the average rates actually realized by almost any large number of companies are below the popular conception of reasonableness. This, in a sense, is encouraging; for what appears to be a growing hostility to profits may not be that at all but merely a reflection of inadequate knowledge of the facts. Improved methods of reporting the facts and more extended distribution of them are clearly needed.

[4] *National City Bank Monthly Letter* (New York), April, 1948, p. 46.

The self-restraint is needed because it is true today and will continue to be true that only a minority of our population derives its *chief income* from supplying venture funds for private industry and trade.[5] We are, therefore, asked to preserve the right of a minority to the rewards for enterprise in which most of us do not share directly in important amounts. This is but a special aspect of the basic problem of a democracy, which is the problem of reconciling the power of the majority with the rights and interests of minorities. It was a problem which was foreseen by Lord Macauley in the past century when there was much philosophic discussion of the possibilities of a democratic society. He predicted that the time would come when the majority would realize its power to clip the wings and limit the rewards of a minority; and it was his opinion that when that time came, a free society would break down. In the last few decades, we are at long last facing that problem. Our success in solving it will be a test of national character and of the fitness of this people and perhaps of any other people for democracy. But if we can solve it in general terms, that is, in the protection of all kinds of minorities, there would seem to be no reason why we should not solve it in the protection of an economic minority whose preservation and encouragement is vital to the economic well-being of all in a free market economy.

[5] This is not equivalent to saying that only a minority are supplying such funds. The number of people who have a direct or indirect financial stake in American corporations (through ownership of stocks and bonds or through the investment of their life insurance reserves and so on) is very great. Indeed, in many of our largest corporations, the number of owners is greater than the number of employees.

# 8

## *CONFIDENCE AND EXPECTATIONS*

THE springs of action in the establishment and expansion of enterprise lie in several different levels of consciousness. We have recognized two levels: first, conscious calculation of monetary rewards, i.e., the economic calculation; and second, some of the universal ambitions and desires which find expression in the search for profits and which supplement that aim, i.e., the hedonistic calculation. We now turn to the third level which influences decision, namely, the degree of optimism which characterizes businessmen and potential businessmen at any particular time. It is probably true that there are other more deeply concealed springs of action, but these are the special interest of the psychologist and will not be explored in this study.

### GENERAL OPTIMISM AND PESSIMISM

The degree of optimism is, in some ways, the most important of the three levels; sheer animal spirits and vitality plus an optimistic view of the future probably provide the main basis for action of any kind. Given that vitality and optimism, the practical question remaining is one of the direction in which activity will proceed; or, putting it in another way: even though the special factors regarding a particular line of action, such as the establishment of new businesses, are favorable, the desired action may not be forthcoming because those special factors are chiefly useful in determining the choice of activity rather than whether we shall have activity or inactivity.

The thought is well expressed by J. M. Keynes, who says:

> A large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full con-

> sequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. Enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere. Only a little more than an expedition to the South Pole, is it based on an exact calculation of benefits to come. Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die;—though fears of loss may have a basis no more reasonable than hopes of profit had before.
>
> It is safe to say that enterprise which depends on hopes stretching into the future benefits the community as a whole. But individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits, so that the thought of ultimate loss which often overtakes pioneers, as experience undoubtedly tells us and them, is put aside as a healthy man puts aside the expectation of death.[1]

Lord Keynes is impressed by the instability which this fact causes; but it seems equally legitimate and realistic to draw the inference that, if our leaders want to contribute to positive decisions by enterprisers, an important line of attack is in contributing to a healthy and optimistic psychology rather than in impairing it.

The essence of business activity, as we have previously remarked, is the assumption of risk. It involves the commitment of funds, or of the time and services of the entrepreneur, and the acceptance (as the reward for such commitments) of any residual amounts that may be left after all costs have been deducted from the value of the product, together with the intangible rewards in the form of satisfactions in the conduct of the business. Despite these latter satisfactions, there must be an equivalence of odds and rewards in order to induce action. This is particularly true when enterprisers have a high degree of free choice in the committing or withholding of their funds and

[1] J. M. Keynes *The General Theory of Employment, Interest and Money* (New York: Harcourt Brace & Co., 1936), pp. 161–62.

services. Stated in this way, business decisions seem to be almost a problem in mathematics. But it is not so simple or concrete as that; with business risks, unlike the game of chance, the odds themselves are not known. Therefore, men's judgments of what the chances are and what the possible rewards are will vary from person to person and, even more important for our present purpose, from time to time. There are times when a given complex of evidence will lead to a favorable forecast and to action, and there are other times when it will lead to a "wait and see" decision. That attitude of mind which conditions all special judgments is called "business confidence."

By this term we refer to a general confidence in the future which influences, but is not the same as, the specific expectations for a particular project. Indeed, specific expectations may possibly run counter to the state of general confidence. For example, an individual who decides upon a general program of short selling of securities presumably has "confidence" that business in general is going to be bad. But while confidence in individual judgments may rest upon pessimism as to the future, the state of mind which leads to positive action in establishing or expanding a business must be based upon an anticipation of a good future of business and of the country, which means a confidence in a general forward movement.

Businessmen refer to this as the "general outlook." This is, of course, a vague term, for it does not imply an appraisal of particular industries or companies. But the use of such a general term is not evidence of loose thinking; rather it implies a profound truth. We are, in fact, too prone to seek specific causes and effects in dealing with such large matters as the growth of a people and to neglect the less tangible, but very pervasive, factor of national psychology. The making of the business decisions, which resulted in the pushing of our turnpikes and later of our railroads into the West and the development of that vast area, cannot be explained merely in individual rational economic terms. Men's imaginations had been fired by the growth of freedom, the successful establishment of national independence, and the tremendous possibilities that obviously lay ahead of the new republic.

Never before the early nineteenth century had there been such an awakening of the individual spirit of men. In all but a few previous ages, individual men had been submerged by groups or by authoritarian forces of the state, feudal lords, church, guilds, and caste systems. Now at last, man was free. The spirit of the times was one of high optimism and profound faith in the future. The building of the West was an expression of that spirit. The general urge to activity was strong and pervasive. In another setting, it might have led to a literary or artistic renaissance. In our setting, the exploitation of resources and mastery of a continent was its chief outlet.

This is not to say that business enterprisers of that day were unmoved by considerations of profit and business prudence, but simply that, because of the general spirit of the time, their estimates of prospects of business success, large or small, were viewed through rosy glasses. That general faith and optimism must underlie any extended and general expansion of the economy.

Specifically, this state of mind has a bearing on the relative emphasis which businessmen, and especially young men, place upon security and adventure. In terms of saving and investment, it is the adventurous ones who absorb and employ the savings of the community. If that spirit of adventure, based upon a healthy national psychology and faith in the future, is strong, we can attain employment of our resources and, what is perhaps even more important, progress. But as Professor Slichter has written: "A nation of security seekers is pretty certain to suffer chronic unemployment. No type of fiscal policy, no juggling of tax rates, no other public policies will suffice to shield a nation of security seekers from stagnation."[2]

This optimistic spirit is important not only in its direct effect upon businessmen. It touches everyone in the community, like the very climate in which people move: the young man who hopes to go into business for himself, the young married couple who are choosing between renting and building a house, and the consumer buying furniture on the installment plan. The attitude of all these persons affects businessmen through the prospective

[2] Sumner Slichter, "More Job Givers Wanted," *Fortune*, October, 1945, p. 194.

effect upon sales, and it affects him also because attitudes are contagious. It is impossible to insulate business decisions from the general psychology of the times.

We of the United States are now at a peculiarly strategic turning point. We have successfully completed the most gigantic and most costly of all wars. As to our fundamental institutions, we have demonstrated that a democratic nation can be more powerful and effective and also freer than the totalitarian governments which, in the thirties enjoyed considerable prestige because they had learned how to make the trains run on time. In other countries, however, there are disturbing trends away from the institutions on which we have built our economy. We stand alone as the only great industrial country which openly avows a system of free enterprise. Comparisons will inevitably be made between our system and these others. Never has faith in our institutions been so clearly put to the test, and never has a period such as the postwar decade been fraught with so great consequences for better or for worse. In this time of testing, it is particularly important that an environment—political, social, and psychological—be maintained at the best possible level.

## DOCTRINES AND MASS PSYCHOLOGY

The national psychology is always profoundly influenced by the doctrines and the trend of thinking of our intellectual leaders. This influence is often underrated because it is not direct; but, to a degree not usually recognized either by the intellectuals or by the laymen, the doctrines being evolved in the studies of academic men and others and circulating in those small groups do ultimately, through publicists and later through public men, finally come to control the thinking of the "man in the street."

Americans with their traditional practical approach to economic and political problems are perhaps more prone than people of other countries to underestimate the force of such purely intellectual movements. There is often a gently tolerant view of the theorists. True, the emergence of the atomic bomb from the work of these "long-hairs" has given a severe blow to this extreme complacency of "practical" men. But ideas in the field of social philosophy can be equally potent, if not quite so

explosive. There are many illustrations of this force: the effect of the writings of Voltaire and other intellectuals on the French Revolution, and of John Locke and many others on our own war for independence and the form of government set up by our new country. One of the most striking examples is in the influence, fully realized only in late years, of Karl Marx, who spent much of his life cloistered in the British Museum but whose theorizing profoundly affects a large part of the world today. One commentator has remarked, having Hitler in mind, that when mad men hear voices in the air and rant with great popular effect, they are usually but repeating the scribblings of some defunct economist. This should not be surprising, for there is much truth in the assertion that ideas have their roots in the past; they have their heritage whether the ordinary citizen or even the political leader recognizes the fact or whether he does not—which is more often the case.

One such intellectual concept, developed during the thirties, which proceeded well along the line indicated from its academic inventors to the general body of citizens was the doctrine of the mature economy. In essence, the theory is that the major forces, which underlaid our economic progress in the past, have been reversed or seriously weakened. These forces, so the theory runs, were: increasing population, geographical expansion, and development of great new industries. These three led to a continual demand for capital goods, and this demand successfully absorbed the savings of the community. Now, it is said, the rate of population growth has slowed down, our frontiers have been passed, and—as far as new industries are concerned—nothing seems to be in prospect that will equal the railroads, the electrical industry, or the automobile industry. Add to this prediction the forecast that with rising incomes the amount of savings will increase, not only proportionately but progressively, and we have the picture of an important reversal of our national economic course. In fairness to the proponents of this theory, it should be said that many of them regard it, not as a pessimistic doctrine, but merely as a realistic view of our problems which can be met by such changes in policy as will be appropriate to the new situation. These changes involve, however, increased

governmental direction of investment and perhaps redistribution of incomes to reduce savings and to increase consumer purchasing power. However these implications be regarded in the eyes of the social philosophers, they clearly do not support the incentives for enterprise which have been discussed or provide the basis for that confidence in growth and expansion which has previously been accepted as a part of the American faith.

We shall not attempt an appraisal of the logical evidence for this theory here. It has been critically studied and point by point denied.[3] In view of the conflicting treatments by eminently competent men, one is led to the conclusion that the popularity of the doctrine which was rather high in the late thirties, and not so high in the years of postwar prosperity, arises from certain traits of human nature, current conditions, and the support which the doctrine gives to certain social and political policies. It is a trait of human nature to look backward to some golden past, and that trait particularly comes into evidence when current problems seem insuperable. At such times people like to conclude that, through no fault of their own, they have arrived on the scene too late, and young men persuade themselves that if they had been born a generation earlier, they would have performed the great deeds that their fathers did. Likewise, as a nation, it is comforting at times to convince ourselves that the times have changed and for the worse.

Also as to social predilections, we have come to recognize the growing interdependence of men in what has been called the "Great Society." This growing social consciousness has led to a commendable humanitarianism which, in some minds, demands a degree of equality of economic status greater than is yielded by the system of individualism. Such trends would obviously be supported by a theory of economic development which required more and more state action. The theory is excellently fitted for this purpose, for it can be used to support such an extension of government functions *as a means* of preserving free enterprise and individual freedom, thus apparently avoiding the head-on issue of collectivism and individualism. Whatever may be the

[3] Cf. George Terborgh, *The Bogey of Economic Maturity* (Chicago: 1945); Marvin V. Jones, *Secular Trends and Idle Resources* (Chicago: University of Chicago Press, 1944).

validity of this view, it may well be that it does not contribute to the patient's confidence in his future, and in this case confidence is itself an important determinant of that future.

Another theory which tends toward pessimism as to the future of a private enterprise system and, hence, to a pessimistic view of the future by enterprisers and investors is that there are inherent in the development of our society certain unfavorable trends of public attitudes which, in our democracy, are being and are bound to be reflected in political action. This view, which one writer[4] has called the "fatalistic view of capitalism," differs from the mature-economy theory in that the former rests upon sociological and political factors, while the latter relies upon tangible factors which are held to limit the opportunities for private investment. Incidentally, those who adhere to one view are inclined to deny the validity of the other. This, at least, is encouraging to one who is not inclined to accept either of them.

This so-called "fatalistic view" harks back to the fact that, in the past century, the great mass of our people were farmers, that is, individual enterprisers; and in the small towns which served those farmers, the enterprisers were small and numerous. These two groups formed a staunch bulwark for the institutions and the mores of capitalism. Today, city dwellers are a large and very important group politically. Most of them are employees, and many have no expectation of ever moving into the employing or capitalist class. Moreover, in the last hundred years, the suffrage has been extended to all adult citizens; and we are beginning to see the force of the argument which was advanced by some critics of popular government that when the balance of political power came to rest with the group who had or felt they had very little stake in capitalism, it was unlikely that they would permit the continuation of the inequalities of income and wealth which capitalism implies. But rather it was predicted that they would use their power to so impair the rewards of ownership as to make that ownership and enter-

[4] George Terborgh, *An Appraisal of the Fatalistic View of Capitalism* (Chicago: Machinery and Allied Products Institute, 1944). This little study admirably summarizes this line of thought and gives a reply to it.

prise unattractive. So runs the doctrine, and it goes on to point out that the attitudes of many public men, influenced presumably by the views of their constituents, are less favorable to business and to businessmen than they were in earlier decades. Political spokesmen sometimes try to compromise on this issue by speaking warmly and acting favorably toward *small* business, but this qualification indicates a weakening of the total approval which corresponding leaders in earlier generations gave to the institutions of private business and capitalism. This trend, it is said, is aggravated and abetted by an alliance of certain intellectuals with the urban employed groups so that an unfavorable attitude toward profits and capitalism has come to be a fashionable intellectual attitude of the day. This is indeed a disturbing picture.

But to it, as to the mature economy theory, there are potent reasons for dissent. We do not need to review them in detail. A general answer is that, among a people with whom freedom of thought and expression and habits of open discussion prevail, there is nothing "inevitable" about these trends of opinion. The judgments about private business, large and small, will be largely determined by its works. They will also be influenced by education and by comparisons with alternative systems abroad. Moreover, it is very questionable to assume that any "trend" of intellectual leaders will continue indefinitely into the future. Indeed, if any generalization can be made about the doctrines of these men, it is that they most commonly react against any general and uncritical tide of thought in whatever direction. Their influence may be expected in the long run to provide an antidote to any excesses of popular opinion.

Nevertheless, complacency is not an appropriate attitude for those who wish for a continuation of our basic economic institutions. Both by precept and by fact, the loyalty of the growing group of urban employed people to those institutions must be strengthened. This is a task of constructive business leadership, of statesmanship, and of intellectual analysis and teaching.

There are other questions on which it is too early to venture forecast. For example, what will be the effect on our national attitudes and on the state of optimism of the increasing proportion of older people and the advancing average age of our popu-

lation? What will be the effect of extended programs of social security? Will the guarantee of a minimum income and of a modest protection against the chief vicissitudes of life enable men to take a more venturesome attitude toward the other uncertainties of employment or enterprise? Or will the costs of providing these minima and, through taxes, the effect of that cost upon the burdens and hazards of enterprise, be so great as to constitute a negative force? Can the ideals of collective security be applied to enterprisers as well as to workers as an economic possibility and as a political possibility? If they could be so applied, would that tend to weaken or strengthen the institutions of capitalism and the general confidence in their future?

All these questions and many others are matters for speculation. This much seems clear: that a country can have the tangible factors of natural resources, capital, labor, and science, and still nothing will happen until those factors are activated by enterprisers; and that enterprisers are not mere calculating machines. The actions of enterprisers more than of almost any other group of the community, involve their attitudes, their desire for security or for adventure, and their general faith in the future. These elements are contagious, and this fact gives significance to the general state of confidence of the country.

# 9

## THE INDIVIDUAL FIRM AND EXPANSION

OUR discussion of the forces leading to the expansion of business enterprises has run in terms of the basic motivation of individuals, including the calculation of their interests at the economic level, the underlying urges which prompt business activities, and the degree of optimism of the business community. It is to such considerations that we have to look for an explanation of the initiating of business ventures and, to a large extent, for the decisions involving important capital expansion. However, when an enterprise has been established, we have, in a sense, a new entity which need not be thought of in terms of the separate individuals concerned but which can be regarded to some extent as a purposeful and decision-making unit with ends and objectives of its own. This entity is the enterprise itself. As we have remarked before, there is a tendency for the business organization to come to be a sort of organism in which the interests of the different groups are fused to such an extent that we may cease to think of the special interests of particular groups —of owners, of different classes of owners, of top executives, and of other members of the managerial staff. The team, as such, has an existence independent of that of its individual members. The business unit has objectives of its own, and there are certain forces which play upon it and which influence it toward expansion.

These objectives give a partial answer at least to the problem of the conflicting interests of the different individuals in the concern. In other words, the leaders and directors of business tend to take for granted the dominance of institutional interests in much the same way as do the leaders of military, religious, and educational organizations. The fact that individual leaders

will ordinarily profit personally by the success of their armies, churches, or colleges may undoubtedly be a factor in determining their efforts; but the day-by-day motivation in most of these cases is primarily based not upon that personal interest but upon the interests of the enterprise. Both in the case of business and in these other institutions, there has thus been effected a synthesis of interests. In many business organizations, and probably typically, this synthesis of individuals and institutions is believed to have been as successfully accomplished among the higher levels of managers as it has been among the corresponding leaders in most other forms of group activity.

Among the objectives of the business unit is that of self-preservation. This refers not to the preservation of the fortunes of the particular individuals—the owners, managers, and so on—but to the preservation of the institution as such. The preservation of a business institution involves the attainment of economic efficiency, of which the most obvious objective test is the showing of profits. Another aspect of this basic objective is the maintenance of solvency, and this implies not merely the operation of the business at a profit but the utilization of the earnings of the organization in such a way as to assure its permanence. Another institutional objective which is highly influential in a competitive society is the maintenance of the position of the enterprise *relative* to the position of others engaged in similar activities. To some extent, this objective can be rationalized in terms of profit-making possibilities, but its prevalence is such as to suggest that it is often regarded as an end in itself.

It is to the forces and motives of the institution and of those persons responsible for its welfare that we now turn our attention.

## MEETING CURRENT DEMAND

One of the requirements which rests upon an enterprise if it is to maintain its position in the market is that it shall so conduct its affairs as to be able to supply the current demand for goods. This minimum aim of a going business may lead at times to a considerable increase in inventory, quite independ-

ently of any cost-price relationship which would determine the profitableness of particular purchases. The general inventory of the country comprises several kinds of specific inventories. There is the retailer's inventory of consumers goods, the manufacturer's inventory of finished goods which he strives to maintain in order to supply the current needs of retailers, the manufacturer's inventory of supplies and of parts, and the corresponding inventories of raw materials maintained by primary manufacturers. In total, these represent a large investment and account for a considerable part of the capital goods of the country. The point to be emphasized here is that the volume of purchase for inventory is determined by the total of demand and the rate of change of that total, as well as by profit prospects.

Decisions as to these current changes in inventory can frequently be made within the organization by individuals well below the level of top management. For example, an increase in inventory of a department store may be initiated by the department buyer and require only the approval of the merchandise manager and treasurer. In many large manufacturing organizations, orders of goods on this account are made by operating men, and these orders frequently run to very large amounts.

Another type of purchase, which in total has considerable bearing upon economic expansion, is that for the replacement of equipment and for additional equipment, if that equipment is required for the meeting of current demands. Needless to say, the rules of different organizations will differ as to the level of approval which must be given; but, in any case, the presumptions in favor of any commitments of this kind which are designed to meet current requirements place them in quite a different category from those that involve an estimate of unknown requirements in the future. Moreover, in many lines, the orders for goods must be placed by retailers and others some time in advance of their delivery; and thus an active demand at a certain moment results in orders for delivery weeks or months later. This fact has the effect, as far as the economy as a whole is concerned, of extending the influence of the current volume of business into the future. From these facts we can draw certain con-

clusions: first, that these decisions, which affect the expansion of the economy, depend primarily upon the current flow of consumer purchases rather than upon the balancing of risks and rewards, as do some of the other entrepreneurial decisions; second, that these decisions are commonly made, or at least heavily influenced, by the operating men as distinguished from the board of directors or committees thereof, which means that the decisions affecting expansion are in fact made or influenced by the organization as a whole and determined by its institutional requirements; third, that, because of the time which necessarily elapses between the placing of orders by people of certain levels, such as retailers, and the sale of goods by those people, these orders will affect the decisions of others regarding their necessary inventories which tend to create a continuing effect upon the volume of business extending beyond the current demand itself.

There are circumstances under which the desire of a manufacturer to satisfy the current demand for goods may lead to a substantial capital expansion of his firm. For frequently a businessman has made a place for himself in the community, and he either must continue to assume the responsibilities which that implies or yield his place to another. For example, a small manufacturer of cement blocks reported that he felt impelled to expand his business and investment because he had established himself as the only local supplier of a certain community. The community and its demands were gradually growing; and if he refused to assume the responsibility for expansion which the growing market demanded, some other producer would invade the field. Since the community was hardly large enough to support two such companies with a reasonable volume, this would mean that the original manufacturer would not be able to hold his established volume and would find himself going backward if he refused to expand. In view of his age and his personal inclinations, he would prefer to continue his existing volume of business and to make no further commitments. Under the circumstances, however, that choice was not open to him. This situation, it will be noted, is somewhat different from the mere meeting of current requirements; but the compulsion is of a simi-

lar kind, since it arises from the responsibility which a businessman assumes for supplying a certain market or part of it.

## COMPETITIVE PRESSURES TO EXPAND

One of the most pervasive forces which impinge upon the business institution, as such, is competition. The effect of this force is that the activity of one firm has a bearing upon the necessary activities of all the others. The standard set by competition is not an absolute level of performance but the relative performance of each enterprise compared to the others. From the point of view of its effect upon expansion, competition has two aspects: it involves someone who changes his method of production or changes his scale of operations; and it involves other persons adapting themselves to this change. Progress or expansion, made as a result of competition, implies that such advance is not made by all enterprisers at once, but by one enterpriser first and then by others following in his train. One of the chief merits of a competitive system is that we do not have to rely upon the progressive qualities of all members of the community; but if even a very small minority act in a progressive way, the others, perhaps even unwillingly, are forced to follow if they are to stay in the game. Competition is thus a highly dynamic force.

Consistent with this view of competition, we can profitably ask: first, what the forces are that prompt the innovator; and, second, what the forces are that prompt the others to follow. An individual enterpriser may be prompted to seek and adopt a method of production which will reduce his costs. The reason for this desire goes back to our view of profits as a differential. Prices in a competitive industry are adjusted more or less precisely to the prevailing costs in that industry. If, then, one producer can reduce his costs below this general level, he will continue for some time to enjoy the established market price and to enjoy a larger differential between prices and costs—that is to say, an increased profit. Frequently, this effort to attain lower costs will be accomplished by the employment of more capital, which in itself is an aspect of economic expansion. But the employment of many kinds of capital equipment is only

effective with a larger volume than the firm had attained before, and so there is a direct pressure to increase the volume of sales. Even if larger volume is not necessary to use the new equipment, the desire to reduce costs may lead to the discard of older equipment and to the purchase of new. Making changes of this kind is particularly common during a period of general business expansion. At such times, when total volume is increasing and new equipment is required, the changes to more effective equipment are thus facilitated.

Another way in which a leader may seek to improve his profit margin is to add new products to a line in an effort to secure additional volume without the necessity of placing greater pressure, in the form of price competition, upon the markets for the established products. Under the conditions of oligopoly (the dominance of a few companies in an industry), there is frequently a conflict between the desire for greater volume and a dislike of so increasing the supply as to precipitate keener price competition. That dilemma can be solved by the addition of a new line. Of course, the new line may create the same problem of pressure upon the market in the new field; but that is not the main field of operation of the originating company and, thus, the price problems created are for others to worry about. (Incidentally, however, this suggests that the effort of one industry to get increased volume and, at the same time, to avoid an intensification of price competition cannot readily be solved for the economy as a whole; the efforts of individual companies to solve it in this way sets up ramifying effects through the pressure brought upon companies in the invaded fields to meet their problem in the same way, thus aggravating the problem in the third field, and so on.)

Still another disturbing move which an innovator may make is an effort to increase volume by better sales methods or other devices. This desire for volume is sometimes prompted by the effort to attain the most economical size of operation and thus to reduce cost. There is, however, a limit to the gains in efficiency to be attained by increased size. These limits are not fixed, but they depend upon the methods of production and distribution being employed. For example, if an industry is con-

ducted largely by hand methods, the effective unit of operation is likely to be small. If, however, expensive and high unit value machinery is devised, it will be economical to seek the larger volume necessary to justify the use of such equipment. The effort to increase volume in order to make possible mechanized production, characteristic of most American industries, has no doubt been an important factor leading to efforts to expand the markets in many of our important lines. The contribution of inventors to the general urge for expansion of sales is evident.

The desire for larger volume is widespread in American industry. The strictly economic consideration just mentioned is only part of the explanation; it is my observation that businessmen in this country, and particularly those who are the leaders, frequently desire increased volume as an end in itself. This attitude is not surprising, for it goes back to the personal motivation previously discussed. Large volume contributes to the prestige of the organization; and since top management of these enterprises tends to identify itself with its institution, volume contributes to the desire for power and prestige. Businessmen are inclined to justify this desire for volume in more concrete terms, but often this is mere rationalizing. The head of a very large organization, for example, explained his desire for cost reduction on the ground that, if he reduced costs, he could thereby reduce prices. When asked why he desired to reduce prices, his explanation was that thereby he could increase volume. When asked why he wanted to increase volume, he groped for an explanation and then said that it might enable him to reduce costs; but that reduction again was valued in terms of its contribution to increased volume, either through lower price or funds available for added sales efforts. The observation of the actions of businessmen and their attempted explanations for those actions leads one to the conclusion that increased volume, to a considerable extent, is an end in itself, not merely (as it is so often described) a means of increasing profit rates.

Evidence to support this view is also found in advertising policies. The effect of successful advertising is to enhance the consumer's acceptance of the product—in economic terms, ad-

vertising has the effect of shifting the demand curve to the right. The enterprise can capitalize upon that shift in the demand curve either by selling the old volume of goods at a higher price or by selling a larger volume at the old price. Generally speaking, American businessmen think of advertising in terms of its effect on volume rather than upon price. Indeed, many of them place such emphasis upon this aspect that they hardly consider the possibility of the alternative.

This urge for volume on the part of an energetic company places obvious pressure upon other companies to maintain their position; and thus the efforts of a whole industry may be directed toward greater volume. The simple fact that most American business leaders would prefer to sell more goods at substantially the same prices rather than the old volume at higher prices is one of the most important features of our economy and, incidentally, one of the points which distinguishes our business system from those of some other countries. It is largely a matter of national psychology and point of view; and, though intangible, it is nevertheless one of our most valuable assets.

In recent decades, the disturbing effects of innovation have been accentuated by systematic industrial research. The formal organization of research departments and the expansion of their activities thus provide another force for economic expansion. This is obviously true when we consider that research is simply an organized program of invention and innovation and that these inventions and innovations are important factors contributing to capital expansion and increased production. There is, however, another aspect which is perhaps not so obvious—that is the fact that research activities, which may have been directed in the first instance to the improvement of an existing product, are very likely to expand beyond the original plan. Discoveries cannot be confined to a nicely planned program, and investigational work is very likely to yield unexpected results. They suggest entirely new products which were not contemplated when the program itself was started. Furthermore, the process is a cumulative one; and every forward step extending the field of knowledge provides the basis for longer and more steps in the same direction. Relative to its potentialities, we have just

barely started upon a program of organized research in industry. Its fruits so far have been gratifying. We are coming to a point in some industries where a research department is a necessary competitive weapon; and once we regard research in this way rather than as mere nonessential trimming, we may expect its effects to be greatly multiplied. For the maintenance of an expanding economy, there is perhaps no one activity of business that more richly deserves encouragement.

Aside from such specific objectives as cost reduction or the increase of volume for its own sake, certain individuals and their firms feel a restless urge to improve processes of manufacture and distribution; this is probably to be explained in terms of the creative urge. In our society, as in any other, this characteristic applies to only a minority of the people and to a minority of firms. Moreover, a firm which is characterized by this restless spirit at one time may lose it as various changes take place: as its position in the industry becomes better established; as the individuals who direct its destinies advance in age; and as the directors' interests turn more to conserving the position or the wealth which they have attained than to improving that position or increasing their wealth. In a dynamic society, the progressive leadership relinquished by those who are inclined to slow down must be taken by other enterprisers (either within old enterprises or in new ones) who will assume the role of trail blazers. This is the requirement of progress, both for the firm or for the economy. Paradoxically, change and progress are the requirements of stability and self-preservation. In our public and business policies, therefore, we should not—in the name of order, protection, stability, or self-government of business—place obstacles in the way of this continuous renewal of the creative urge.

To a large extent, the efforts at expansion, cost reduction, and product improvement would not appeal to a whole industry if those matters could be considered as a common policy by the whole group. For often they do not increase total industry profits or even the total industry volume.

In the early 1920's, for example, certain people in the refined

sugar industry took note of the tendency toward packaging which had developed in other lines of consumer goods. There was no reason for thinking that the American people would buy more sugar if it were put up in boxes than if it were sold in bulk. Also, it was by no means clear that they would pay a sufficiently higher price for the packaged product to cover the cost of packaging or, at any rate, to yield a larger profit on the packaged sugar than on bulk sugar. Nevertheless, the situation that faced a single company at that stage was that this move was such an obvious one that, if the company did not make the move, some other company would do so and the prestige and consumer preference that result from leadership would go to a competitor. One company did start packaging and, the move having been made, other companies felt impelled to follow. As soon as they had all done so, the competitive advantage disappeared; and it is quite probable that the industry as a whole gained no advantage from the improvement. This illustration could be multiplied many times over. The placing of cellophane on cigarette packages, the introduction of improvements on automobiles, and many other instances suggest that much of the expansion in activities and improvement of products have come from the desire to keep pace with competition or to anticipate it. In many of these cases, the individual entrepreneur has little choice.

Now, when one firm has adopted a new method of production or distribution or has instituted an unusual drive for volume, what are the forces which lead the others to follow? Again, the first strictly economic explanation is in terms of the relation of costs and prices and their effects upon profits. The new cost level which has been attained is likely to become the basis for a new price level; and if, therefore, a particular company is not able to reduce its costs accordingly, it will find that the margin which represents profits has disappeared. As Mr. Charles R. Hook, president of the American Rolling Mill Company, testified before a congressional committee: "When a fellow comes along with a method of doing a thing that you have got to adopt to keep up with the pace, you go out and break your

back to find the money to do that job to keep from going out of business. . . . ."[1]

If the change which has been instigated by the innovator results in lower costs and lower prices or the prospect of lower prices, this explanation is perhaps sufficient; but in other cases, the change may simply involve the capture of a larger part of the market by the innovators. One of the major objectives bearing upon that type of situation is the widespread desire among American businesses, particularly perhaps among the larger ones, to maintain or improve one's share of the market. In fact, in some large enterprises, the maintenance or the improvement of an existing per cent of the market held by the firm appears to be the most important objective, even overriding at times profit rates and other evidences of success. I have asked a number of businessmen for an explanation of the importance which they attach to this percentage. It is, after all, a fair question, for why should an enterprise not be more concerned with the absolute amount of sales? One might expect that, since the firm has a certain productive capacity, its aim would be to maintain a volume well adjusted to that capacity. With the rise and fall in the total market, this would call for an increasing percentage in some periods and a declining percentage in others. Various explanations are given. One is that the cost-price relationship is involved. In the automobile industry, for example, some observers point to the unfortunate results in terms of profits which accompanied the declining percentage of the market held by one prominent company over a period of two decades. In this case, however, the declining share of the market was accompanied by a declining absolute amount of sales, and hence this explanation of the emphasis upon proportions is not too convincing. Another suggested reason which seems to have more validity is that, in the case of a consumer product, a trend toward or away from a certain line of goods is cumulative and is difficult to reverse. "Nothing succeeds like success"; and once a company has started to slip, it is difficult to check its downward progress at

[1] *TNEC Hearings*, Part 30, p. 16, 437. See also Norman S. Buchanan, "Anticipations and Industrial Investment Decisions," *American Economic Review Supplement*, March, 1942, pp. 141, ff., for a discussion of this entire subject.

any reasonable level. A similar explanation can be offered in terms of distribution facilities. If dealers observe that a certain make of car, for example, is growing in popularity, there will be little difficulty in getting distributor outlets; whereas if the trend is in the opposite direction, its effect may be accentuated by the desertion of existing distributors and the difficulty in securing others. Still another explanation is that the proportion of the business secured provides a measure of efficiency. This yardstick can be applied to particular operating divisions of a multiline company; to measure the efficiency of such divisions, it is better to use the percentage of the business in the "price class" as an index than the absolute amount of sales because the latter is subject to influences, such as national income and the general state of the economy, which are quite beyond the control of any unit. On the other hand, the top managers can well take the position that, whether business conditions are good or bad, the unit under observation should have maintained its relative position. This is an important test because it equally measures the ability of managers to adjust themselves to a shrinking market or to exploit the possibilities of an expanding market. Likewise, for the company as a whole, the proportion of business obtained is an objective test of efficiency; this fact is presumably significant to the directors and stockholders and provides a basis by which the business ability of management can be estimated by other members of the business community and the country at large. Moreover, the desire for volume for its own sake requires that, at the minimum, one should hold his position in the race; and it provides a psychological basis for the emphasis on proportion of the market in addition to the more tangible ones mentioned.

This whole process of change made by the innovators and adopted by the followers is, in a sense, a process of destruction. Plant and equipment which were perfectly satisfactory at one stage can lose their value quickly when new and improved methods are introduced. Obsolescence, as truly as physical deterioration, is a destroyer of values. This rapid rate of change (and, consequently, of obsolescence) and the destruction of old values in this country are often viewed with amazement by foreign business observers. They are, of course, the price of progress. Never-

theless, the question might be raised whether the process in total leads to increased or decreased investment measured by the aggregate value of capital goods. But as old values are destroyed, new ones are created; and the net effect is an increase in potential production. Likewise, expansion of one firm may force contraction of others. But particularly where fixed capital is involved, this disinvestment in some units and in some forms cannot proceed as rapidly as investment in others. The building of a new railroad, to take an extreme example, does not mean that another railroad can or will drop out of existence; and the building of more ships at a time of high freight rates does not lead, then or later, to the scrapping of an equal amount of old tonnage. In this process of "creative destruction," there is continual overlapping of the old with the new, leading to a net expansion of productive facilities, employment, and output.

## PRESSURE OF OVERHEAD COSTS

The productive process involves the combination of the different factors of production. These may be defined in the broadest terms of land, labor, and capital or in terms of specific machines used with other machines and with a certain labor supply. There are certain combinations of these factors which will be most effective, and it is one of the major functions of the entrepreneur to combine these factors in this way. To bring about a perfect adjustment of the many items, however, is not possible; and this is to be attributed not merely to the limitations of entrepreneurial ability but more to the fact that many of these factors are not infinitely divisible. For example, if a large machine for molding automobile bodies is essential to effective production in that field and if a plant has two of such machines, it is not possible to increase that particular productive factor by 10 per cent; one must either go on with two machines or increase investment by 50 per cent. If, then, we take that machine as the standard and try to adjust the amount of labor and other factors to it most effectively, we will encounter the same difficulty with some of these other factors. The result will be that the factors are never perfectly in balance. But the firm already has commitments in a number of them. For this reason, if a firm has too much of

one of these "fixed" factors, it cannot correct the imbalance by reducing that one. The only feasible way is to increase the other factors and to increase the volume of business accordingly. This, in brief, is the nature of the pressure of overhead costs. It will be observed that we are using this term in its broadest sense, referring to the fact that in practice every concern has certain productive facilities which are not utilized to capacity; and this fact results in an effort to gain the volume which would give better utilization of these facilities. The general principle takes a number of special forms.

If a manufacturing process requires the purchase of a certain kind of raw material, it may well be found that not all of it can be utilized in producing a single product. The effort to use the remainder may well lead to a considerable expansion of the business. The meat packing industry is a striking instance. It is not possible to buy hogs that will produce only pork chops. This fact leads by successive stages, to producing lard, sausage, and other meat products, and then to utilizing the minor by-products, such as hides, bristles, and bone. Thus, an industry which started to produce food products finds itself pushed on by this economic force into lines which are, in many respects, far removed from its original purpose.

Another notable example is in the chemical industry. A certain well-known company had its origin in the production of a few rather simple products made from the brine drawn from their wells. But when the necessary ingredients for these original products had been extracted, a large part of the original brine was still left. Ordinary ingenuity, powerfully reinforced in recent years by chemical research, has led to the use of this left-over brine; and the procedure has gone from one stage to another until this company produces hundreds of different products. As a member of the company put it: "The history of our company has been conditioned by the fact that whatever we make, we have something left over." In cases of this kind, when competition has worked itself out and has established the market price for the main products, it may appear at any stage that the profits of the company are primarily dependent upon the successful utilization of its by-products.

The increased use of machinery has led, in a similar way, to a desire to attain more complete utilization of those machines. It is rarely possible to adjust the number of machines to the demand for them so that full utilization can be obtained without some excess capacity. Even if it is possible to accomplish this perfect result in the relation of total demand and capacity, it is commonly true that there are either seasonal or cyclical variations in the productive load. Any one of these circumstances, that is, genuine overcapacity or seasonal or cyclical overcapacity, suggests the desirability of adding products to the original line which can utilize these same machines; and this again leads to expanded production. This problem never seems to be solved, for when a new product is added for the purpose of attaining more complete utilization of the existing plant and equipment or raw materials, that new product usually requires some new equipment or material. Then one starts all over again to try to get more complete utilization. The part of wisdom is to know where to stop in this dog-chasing-his-tail game; and, of course, well-managed companies do find a stopping point.

The two instances of efforts to spread fixed costs just given are clear enough. It is perhaps not so clear that a similar force is at work in the case of the marketing organization and facilities. A salesman is engaged, for example, to sell the one product of a new company. It soon becomes clear that this salesman could, with little increased expenditure of time or money, handle a second product. If the distribution cost is a large part of the total, there is here a reason for creating a new product to effect better utilization of his time. This argument for an expanded line applies even more to the sales organization as a whole, including, as it does, the expense of the home sales office.

Likewise, advertising has its overhead aspects. A large cost will be involved in establishing the name of a product in the consumer's mind and creating a favorable reception for it. Once that has been done, it will require but little more cost to make that name cover additional allied products. Indeed, it may actually be easier to accomplish the result with a line of goods than with a single product, especially if the new products are desirable ones from the consumer's point of view, for then each product tends

to support the other. Thus advertising, especially in the case of well-known branded products going to consumers, may become a force tending toward the addition of new products to the advertiser's line.

Then the ownership by a company of trucks, warehouses, refrigerator cars, and other specialized distribution equipment may lead to the desire to make more complete utilization of that equipment. A certain purveyor of cheese and similar products, for example, has built up an extensive line of goods, the common denominator of which is a degree of perishability which requires or can effectively use the prompt distribution provided by their truck delivery system.

Another element of fixed costs lies in the managerial abilities which a company may have built up. A well-integrated and imaginative management is an asset which bears an analogy to efficient plant or equipment, and the influence of this type of management can frequently be extended over a larger number of products than the company originally produced. This pressure for expansion to get better utilization of managerial abilities varies widely between companies. It is more pronounced in the case of the small or medium-sized concerns than it is with the very large ones. The reason is that even a moderate-sized concern must have a president, a sales manager, a production manager, and certain others who represent a minimum staff for effective performance. It often occurs that, once such a concern is in operation, it would be possible substantially to increase the volume of business without increasing the numbers in the staff. In a number of instances which have come under observation, this fact has led to the extension of the line of goods or to an effort to get additional volume in other ways. In the large enterprise, there are already a number of managers in each of the departments mentioned, and that number can be and probably has been quite accurately adjusted to the existing line and volume of business. In other words, the managerial staff is more highly divisible in the large concern than in the small one and can, therefore, be better adjusted to the other factors of production.

Another consideration, which in a sense falls in this cate-

gory, is the desire to utilize existing funds in the business enterprise. If the concern is profitable, it has the opportunity of distributing these profits to the stockholders, who in turn may make independent judgments as to the further investment of them either in this concern or in some other. Hence, it might appear that funds secured from the operation of the business are, in fact, infinitely divisible and that the amount retained for use could be accurately adjusted to the other factors and requirements of the firm. Sometimes, however, there are obstacles—the owners or managers may have a decided preference for keeping the funds in the same enterprise. For example, if a meat packing firm is largely owned and controlled by one family, it might well be that, since the owners are familiar with that line of business and have confidence in the management, they would prefer to reinvest their funds in that line even though somewhat larger profits might be made by venturing into a new field. The reasons why managers might desire to keep the funds under their control are quite obvious. Such situations create a degree of immobility of capital, but they also have the effect of leading the management to strive to increase the volume of business.

All of these factors, then—the desire to utilize by-products and the desire to get best utilization of productive plant, marketing facilities, managerial skills, and funds entrusted to the business—create a pressure for expansion. They all arise out of the fact that the productive elements of the concern are never in balance. Some factor is always in a sense calling for more work to do; and if we attain the necessary volume to keep that one busy, we will have to increase some other factor—rarely just enough, but more often a little too much.

## SECURITY FOR THE ENTERPRISE

It is obvious enough that an important business incentive is the individual's desire for protection of his assets in order to sustain economic self-preservation. But this desire for security applies, not merely to the individual's fortune, but to the security of the business as an entity. Frequently, of course, the two are parallel and intertwine; but numerous instances are known to most of us in which this explanation does not give

the whole story. It is not uncommon to see an enterpriser strive for the continuity and preservation of his business even when it appears that, from the point of view of his own monetary gain, he might better wash his hands of it and "call it a day." An explanation of such an attitude probably involves a complex of motives, such as pride of accomplishment, loyalty to business associates, and others, which can be summed up in loyalty to the enterprise as such.

This institutional interest in security takes the form of a high regard for solvency—that is, for a continuing ability to meet the obligations of the firm. This emphasis upon solvency and the economic preservation of the firm may serve either as a spur to expansion or as a check upon it. It may lead to extreme conservatism, as when a company retains existing plant and equipment even though better equipment is available.

Thus, at first sight, this desire for security appears to be a negative force in its effect upon economic expansion; and indeed it does have that aspect. Expansion into new lines, building of larger plant, purchase of new equipment, opening and cultivation of new markets—indeed, almost anything that may be done by way of expanding the scope and activities of the firm—involve the giving of hostages to the future; and the future is at best unpredictable and fickle. Certain industries have gained a reputation for being dominated by this objective. In the past, one of these has been the railroads. Without attempting to judge the degree of truth in this view, we can observe that there are certain features in that industry which would favor such a policy. At many places, certain railroads do not have the direct competition of other railroads. (In those cases where direct competition does exist between several lines running between important termini, the unwillingness to make improvements involving capital commitments is less marked.) Moreover, virtually no new railroads are being built; and thus this source of new competition and of new methods is not present. Still further, it is believed that such a degree of "banker control" as exists here is conducive to efforts to conserve the existing assets and tangible properties rather than to growth and progress. But the railroad industry can also serve to illustrate the

fact that in a changing world the only hope of real security is in change and progress and, in some cases, expansion. With the development of the motor truck, the motor bus, and the airplane, this industry finds itself in such a changing world; and there are numerous evidences that the new situation has been recognized and is leading to a more progressive attitude.

The type of ownership of the firm and the interest of owners in it may also have a bearing upon its dynamic or conservative character. For example, in two fairly well-known concerns, the owners are now the heirs and other dependents of the original founders. In both cases, the management regards its major responsibility to be the continuance of the company and its ability to pay the existing dividend rate. This object of the management has become so much stronger than any desire to increase the rate of return that it has led to unusually conservative policies. There is also a possibility that this situation will develop among some of our giant organizations whose stock is widely held by widows and by charitable and educational institutions. An ownership situation of this kind does not always lead to conservatism, for other factors, such as the personal ambitions of managers and the fact that security in a dynamic industry can only be maintained through progress, may override the tendency of such concerns to seek security through conservatism. But the danger implicit in these types of ownership should be recognized.

The seeking of security for a firm, as for an army, can be regarded as a problem of defense. But in the one, as in the other, there is much truth in the maxim "the best defense is an attack." An industry or a company may, in the face of declining markets for its goods or a new kind of competition, retire behind strong fortifications in the form of a "strong financial position" or conservative production and selling policies, or it can go forth to meet the enemy. Prior to World War II the French constructed what they hoped was the impregnable Maginot Line, designed to withstand assault from the east. More significant than the line itself was the attitude of mind which it symbolized. In the face of a highly mobile army, it proved disastrously ineffective. Mere defense has often crumbled before (or been outflanked by)

an active attack. There is evidence of this Maginot Line philosophy in some business institutions. The analogy can be carried a step farther by the observation that the strongly defended position has its value if it can be made the point of departure for the attack. So with business firms, the desire for security may lead to one policy or the other.

A particular way in which a fundamentally defensive attitude may lead to positive action is in the attempt to gain security through diversification. One of the hazards facing a business arises out of having "all the eggs in one basket." There are a number of instances in which concerns recognizing this danger have added allied lines or lines which will be complementary to their original products in the effort to gain stability and security. The extension of the activities of a firm in this way, of course, involves expansion of the firm itself; and the action of the firm impinges upon other firms in the lines which are entered. Thus, ramifications which may extend throughout the newly entered industry, and which may impair stability there, are set up by the effort of the one company to fortify its position.

If it is correct that this regard for the security of the enterprise is different from and sometimes more potent than the individual's interest in his own security, that fact will have implications for tax policy, labor relations, government administrative controls, and the actuality or threat of adverse legislation affecting the firm itself. It suggests that burdens placed upon individuals will not be such a serious deterrent to enterprise as will similar burdens placed upon the business entity.

## MERGERS AND COMBINATIONS

The incentives and compulsions for expansion that rest upon the business enterprise as such can be satisfied, in many cases, by the mere process of expansion through the purchase of existing properties or mergers with other enterprises. When businessmen are asked to consider the possibilities of expansion, they frequently think first of buying out a competitor or forming a merger. We have remarked in Chapter II that individual business expansion of this kind may have little significance from the

point of view of the volume of general economic activity. Indeed, the popularity, at certain times, of this form of business expansion may be regarded as unfortunate because it tends to divert normal business forces to ends which are socially sterile.

Despite this general judgment, however, it must be admitted that such moves, since they involve a rearrangement of the competitive pattern, may indirectly have significant effects. For example, if the organizers of the new company buy up a number of independent plants, they may not take over the previous owners or managers as part of the new organization. These men, aided by the funds which they have received for their old property, may well seek new activities in the same fields or in different ones. One young man managing a small company asserts that, if his concern were purchased or otherwise absorbed by the dominant company in his field, he and his associates would merely move to another town and establish a competing plant. He feels confident that, with their experience and technical knowledge, they could do so successfully.

A somewhat similar direct effect may follow from the extension of the activities of the large concern, which may immediately have the effect merely of displacing certain independent firms that have previously served it. If, for example, an automobile company decides to shift in a particular territory from sales through an independent distributor to sales through their own branch, we again have the erstwhile dealer placed in the position of seeking new fields of activity. It is impossible to say what this field would be or what methods he would employ; but an ingenious businessman fighting for his existence is very likely to find some such new activity, and his effort may well contribute to genuine expansion.

The social effect of such movements will also be influenced by the objectives of the absorbing company. Frequently, that company (as was indicated by its desire for growth) was dominated by more dynamic qualities than was the concern which it absorbed. A number of instances have been observed in which a growing and progressive concern has picked up the property of concerns that had been rather sluggish in their policies. The

justification for the purchase was that the new owners would make better use of the property than the old ones had done. This is, in a sense, a case of extending the superior management of the purchasing company over a property which was deficient in that important element.

For these and other reasons, therefore, we must recognize that while there is no prima facie reason for expecting economic expansion from mergers, they may, in fact, indirectly set up forces in that direction.

## CONCLUSIONS

We have seen that when we talk about incentives for greater economic activity we should not confine ourselves to the motivation of individuals, even though it is recognized that this factor underlies all economic activity. In addition to this factor, we must consider the concept of the business institution, as such, which is subject to certain compulsions growing out of the requirements for its own preservation, growth, and successful conduct. These compulsions grow in part out of the existence of overhead costs, which in turn are caused by necessary unbalance existing between the various factors of production. Greater economic activity, however, depends even more upon the existence of a competitive environment. By virtue of the two aspects of competition, namely, the initiating of changes by some and the following of those changes by others, we have in a competitive society a force which multiplies the effect of a few innovators. As long as competition largely controls the relations of business enterprises to one another, progress can thus be maintained even if the larger number of individuals and enterprises are not dominated by any desire for progress. Here is a great social advantage, for in view of the distribution of qualities among business leaders (as among all other human beings), it is too much to expect that, even in this country, the mass of businessmen will be markedly characterized by progressive qualities. But in a competitive system, even a relatively few can be the "salt of the earth by which the whole is flavored." It is evident that for the success of this

system, involving the interaction of innovators and followers, an adequate supply of these leaders must exist; and, further, an environment must be maintained in which it is impossible for the followers to insulate themselves from the impact of the dynamic leaders.

# 10

## *NEW FIRMS AND OLD*

In the year 1940, which for this purpose is fairly representative of the prewar period, there came into being in the United States about 380,000 new businesses.[1] In view of the large number of business failures and the vicissitudes that face any new concern, this record is a strong testimony to the virility of American business enterprise. It means that there were somewhat over two new businesses born in this country each minute of each business day of a year. That striking rate of business births represented a decline from that of 1925, the highest prewar year, when the corresponding number was 496,000. However, there is evidence in the record of incorporations that still higher levels were reached in the year 1946. This postwar experience seems to indicate that there is no definite secular trend toward a reduced rate of business births. On the whole, the establishment of new businesses shows a relatively high stability as compared with other aspects of economic activity. The record, it is true, indicates a degree of positive correlation with the business cycle; but this is far from perfect. The reason apparently is that there are counteracting forces: on the one side, a large aggregate volume of business is obviously favorable to the establishment of new ventures; but on the other side, such periods provide unusually good employment opportunities at all levels, and such employment is frequently an attractive alternative to the establishment of one's own business. Thus, during the depression years, many businesses were established in order "to make a job" for a man who could not find a satisfactory one elsewhere; and the sharp increase in the demand for

[1] Based on Dunn & Bradstreet data as compiled by Alfred Oxenfeldt, *New Firms and Free Enterprise* (Washington, D.C.: American Council on Public Affairs, 1943), chap. iii.

employees in the early wartime prosperity tended to decrease the number of business births.

## IMPORTANCE OF NEW ENTERPRISES

Expansion of employment and production can be effected either by the increased employment and production on the part of existing firms or by the establishment of new firms. From the point of view of the direct effects upon employment and the productive utilization of our resources, there may be little to distinguish them, for an equal contribution is made to the solving of those problems by the expansion of a company to employ 1,000 additional men or by the establishment of a new company to employ an equal number. A generalization as to the effectiveness with which they will be employed in the two cases cannot be made. But there are indirect effects which are different and which lead to the belief that the establishment of new companies is particularly important and to be desired.

In the first place, the new firm is likely to imply a fresh approach and, therefore, to be particularly favorable to the introduction of new methods, to the production of new products, and in general to an exploitation of the results of research and invention. Admittedly this is not always true. A large number of new firms are established to carry on business in much the same manner as the existing firms. They merely represent attempts on the part of newcomers to edge their way into an already occupied field. It is also true that large concerns have certain advantages in innovation. Nevertheless, in many lines, new firms bring into the industry not only new enterprisers but new ideas which are helpful in maintaining the dynamic features of the industry.

Furthermore, in a number of established industries, there is a tendency for competition among the existing companies to take the form of a sort of armed truce instead of the active and aggressive methods which would be more fruitful in product improvements and cost and price reductions. This armed-truce attitude does not, as is often assumed, imply collusion, although that possibility is also present. Rather, it ordinarily implies a recognition of established positions of the different companies

and a general unwillingness to upset this comfortable situation by excessive price competition or other disturbing policies. In social relations, generally, there is a tendency for this kind of stabilization to develop. The "cake of custom" becomes set, with the result that the forces which would lead to innovation are discouraged. The new company is not bound by these same considerations or subject to the same forces. Indeed, in the nature of the case, it must force its way; and in doing so, it tends toward the reestablishment of fluidity in the situation and toward a shattering of the "cake of custom." In the course of time it too may become one of the happy family; and when that time comes, it is desirable to have still newer companies entering and striving to enter the industry.

There are some industries and types of situations in which this energizing force of new entrants may not be so apparent. Thus, in the case of an industry having relatively few large producers and a homogeneous or highly standardized and stable product, the newcomer will very likely refrain from immediate price competition; he knows that in such cases price is such a decisive factor that the old companies will feel impelled to meet the new price immediately. Hence, that competitive weapon would be futile; and since the newcomer realizes that fact, he tries to avoid it. Nevertheless, even in such cases the newcomer must ordinarily make some positive appeal for patronage either through quality of the product or service or through secret price concessions. Even if these do not develop at once, there still is the increased pressure caused by an added supplier; and this pressure is favorable to change. But in most cases the effect is more direct, for these instances of stable and identical products are relatively limited in the whole economy; and with most products, such as automobiles, clothing, household appliances, furniture, and prepared foods, there are sufficient differences to permit such a degree of price and quality variations as will make possible direct results from the new competition. Whether direct or indirect, the best answer to the so-called "decline of competition," about which many people are justly concerned, would seem to be freedom of entry. Even the potentiality of new competition has some effect, and the actuality is even better.

The entrance of new companies not only provides competition, in the sense of rivalry to gain a part of an already occupied market; but it also applies the test of effectiveness to existing methods and to the larger question of the most appropriate scale of operation. There are, of course, advantages of large-scale production which are more significant in some industries than in others; but there are also disadvantages. The question of what is the most effective size of a producing unit can be best determined when there are companies of various sizes striving to perpetuate themselves. An industry which is dominated by large units may well go on in that way through sheer inertia except for the challenge which the new, and usually smaller, firm offers to it. From the point of view of the health of the economy, there are advantages in having existing methods of production and the existing scale of operation challenged by newcomers. The principle of variation, competition, and survival of the fit are as important to economic evolution as to biological evolution.

## SMALL BUSINESS AND NEW BUSINESS

The question of new business is closely related to that of small business. A new business is, in fact, usually a small business. Indeed, it is practically always small in relation to the industry it is entering; at least that is true when the concern is genuinely new and not merely a merger of existing companies.

From the point of view of business incentives and the motivation that controls enterprisers, there is greater variety within the category of small business (however one may define that term) than in big business. This diversity is partly explained by the fact that small business is commonly closely identified with an individual, usually the owner but occasionally an employed manager. Indeed, for many businesses, the old aphorism that the institution is but the lengthened shadow of the man is essentially true. That identification of individual and business is obviously more complete in the small concerns.

Since individuals differ so widely in their interests, energies, tendencies to daring or to conservatism, intelligence, and ability, it follows that the organizations which they so closely represent

will vary likewise. The policies and objectives of the large concern are likely to be determined by the composite views and interests of a number of people, with the result that extreme positions or interests of certain individuals will be partially neutralized by others. The result is, then, that large businesses, representing groups of individuals, bear a closer resemblance to one another than do small businesses that represent single individuals. Of course, there are differences between companies in both categories; the distinction is one of degree.

Small businesses also vary more widely in legal form. Some of them are individual proprietorships; some are partnerships; some are corporations. On the other hand, practically all of the large businesses (if we exclude some of the large co-operatives) are corporations. This, like the previous point, suggests a greater difficulty in dealing with small business as a single category than with the larger business—a difficulty which is great enough in either case. For example, the corporation income tax is, among large businesses, merely a general business tax because practically all of such concerns are corporations. In small industries, it is a tax levied upon a particular form of business organization. Hence, in the case of small business, we have two questions: first, the propriety of levying a tax on the business entity as such; and second, the discrimination which a corporation tax makes against those small businesses that have chosen to incorporate.

All this possibly throws some light on the confusion which always seems to surround any discussion of small business. The mere fact of smallness, which itself is not easy to define, is overshadowed by the other characteristics of these businesses which are not common to all of them.

When we consider small businesses as a group, we can see certain values attaching to them that extend beyond the effects which they have upon economical production and distribution. From the political and social points of view, a system of free enterprise which comprises many thousands of enterprisers is in a more defensible position than a system in which mammoth corporations are most typical. This is not, as is sometimes cynically implied, merely because many small businessmen have

more votes than a few big businessmen. The difference goes deeper than that; for when the man in the street, who himself has no ambition to become a business enterpriser, comes to identify free enterprise with the few industrial giants, his ardor for preserving the system will cool. All the statistical evidence of efficiency that can be adduced will not serve so well as the evidence of a man's own eyes that young men of his own acquaintance have had the opportunity of shifting from the employed to the employing class.

These considerations—that is, preservation of competition, maintenance of industrial effectiveness, and maintenance of individual opportunity—probably underlie the American prejudice against bigness in our industries. This attitude is a long-standing one and was represented in the last century by the Granger laws, and it probably underlay the Sherman Anti-trust Act. It has also been a part of the attitude of many true liberals in later days, so eloquently stated by Justice Brandeis of the United States Supreme Court.

The relation between the problem of small business, which has received so much political and popular attention in recent years, and that of new business should be kept in mind. To some extent, as we have suggested, they have the same problem, since new businesses are usually small; but many business units are small because that is the natural scale of operation of the industry in which they are engaged. For example, grocery stores and other convenience-goods stores tend to be small establishments. Clothing stores tend to be somewhat larger, and department stores are still larger. A manufacturer of technical equipment, such as laboratory supplies, is of necessity smaller than the manufacturer of automobiles or steel. Furthermore, in industries that are best adapted to small-scale operations, there are companies which employ only a few hundred men and which are leading companies in their industry. These smaller companies present many of the same features of leadership and domination as does the largest company in the steel industry. While we should be concerned with the genuine problems of small business units and with the preservation of the social and political values associated with them, the greater emphasis, in

my opinion, should be given to the encouragement of new companies whether they are small or large. For new companies are peculiarly valuable in preventing too great a degree of fixity, either in methods or competitive relations, and in providing the energizing forces that lead to expansion.

### HOW INCENTIVES FOR STARTING AND EXPANDING A BUSINESS DIFFER

While, in the broadest sense, the incentives for enterprise apply both to the establishment of a new business and to the expansion of an existing business, certain differences are suggested by our previous discussion of the special and detailed incentives. We have noted that among the motives controlling the day-by-day conduct of business are the desires to meet current demands for goods, to keep up with competitors, to increase volume partly for its own sake and partly to reduce costs, to maintain or increase profit margins, and, by these and other means, to gain security for the enterprise. While these motives contribute to the expansion of existing businesses, they do not provide the reasons for starting a business. To find those reasons, we have to turn to the simple desire for income and, even better, to that different level of motivation represented by the desires for power, prestige and social approval, the creative impulse, the competitive impulse, and the desire for independence. The extent to which these desires exist and the possibility of satisfying them through the establishment and conduct of business will largely determine the birth of new business enterprises.

One reason why these basic considerations are more needed to explain the establishment of businesses than the expansion of them is that freedom of choice is more pronounced in the former case than in the latter. Both the establishment of a business and the expansion of it, of course, require decisions; but the actual freedom to decide one way or the other is greater in starting the business than in its later conduct. Indeed, business is like all other human activities in the respect that commitments, made as we go along, limit our later freedom of choice. The origin and development of a business is a process of making commitments, which means yielding up freedom of action.

Thus, the typical new enterpriser, who has a few thousand dollars in the bank and who is considering the starting of a business, has, at that moment, a greater freedom than he will ever have again. For having made the decision, he has committed himself in two ways: first, as to his own occupation, and, second, as to his funds.

But having this freedom of choice at this crucial hour of decision, he will, if he acts rationally, presumably insist that the terms shall be attractive. As to occupation, this ordinarily means that it must be more attractive at present or in prospect than his present occupation; for the studies of the originators of businesses indicate that they were usually employed people. For this practical reason, the "burden of proof," in a sense, is on the starting of a venture; inertia works for continuing as an employee. As to his funds, the business originator must regard the profits in prospect, considering the risks and probabilities involved, to be more attractive than the liquidity of funds which he enjoys before taking the step. As to his choice of occupation, he must regard a business of his own to be superior to employment, not only in income-producing possibilities but also in such intangibles as the desire for independence ("to be my own boss"); the prospects of a pleasant occupation; prestige; and freedom of control of the enterprise. Moreover, the extent to which these desires can be satisfied will presumably have a bearing upon the rate of profit which will be sufficient to make up a total reward acceptable to him.

If, therefore, we can imagine that society wants enterprises started and is driving a bargain with the prospective enterpriser, it will be clear that establishing such concerns must offer prospects of financial reward which appear more attractive to the enterpriser than his present financial liquidity. That means that the reward related to risk must be mathematically reasonable in the sense that was developed in Chapter 9. But it also appears that the monetary reward will not have to be so high if the reward in the intangible factors is greater—in other words, if society wishes to induce this desired action from men who have free choice, it will find it necessary to pay a higher price in terms of profits if it is niggardly in its intangible rewards.

If society is niggardly in both types of reward (incentives), it will fail to get the supply of enterprise needed to employ its resources fully. In the economist's language, a point of equilibrium would be reached, in that case, at less than full employment. We might, thereby merely stabilize depression.

Presumably, society will find some way of avoiding this last result. If it does wish to avoid depressions and still retain free enterprise, it can do so more cheaply in terms of money profits if it is generous in the intangible rewards and incentives, that is, if it provides a favorable social and political environment for enterprise.

Profits are needed to secure expansion. But does expansion in the form of new business births differ in this respect from the expansion of established firms? From our previous analysis, it appears that the prospects of profits must be brighter to induce the former type of expansion. This is primarily because of the greater freedom of choice in establishing than in expanding a business. But although an enterpriser might say that he would not build a new cement plant unless he could foresee a return of 10 per cent on his investment, if he already has such a plant he might put additional capital into it in order to protect his past investment, even if that investment is yielding and promises to yield only 5 per cent.

The pressure of competition applies particularly to existing companies. The general run of existing companies are frequently impelled to make changes, which often involve expansion of their activities, by virtue of a corresponding change which has been made by one or a few leaders of the industry. Moreover, in some industries it is to be normally expected that improvements will be made by some; and therefore a regular policy is adopted of adding new and better equipment or extending sales, and these are forms of expansion. An automobile manufacturer, for example, introduces a new line of cars or perhaps improves upon his existing line on the ground that if he does not do so some competitor will; for it is important, even from the point of view of defense of his position, to keep at least abreast, and preferably ahead, of the procession. But this act forces his competitors to expand their investment in their attempts to hold

*their* positions. Thus a given expansion of investment gains a cumulative effect. This line of thought has become so well established in many companies that the necessity for progress on this basis is taken for granted—research departments are kept busy, and creative engineers and designers are employed as a matter of course. In short, there is a sort of momentum which carries an existing company forward; and improvements and expansion are the requirements, not only of competitive advancement but for the preservation of a competitive position.

This competitive pressure tending toward expansion applies even to companies that are showing losses. Such companies, as well as the profitable ones, may strive for security through the adoption of new and better methods; improvement in products; and expansion of plant, equipment, and employment. Such a company may have an aversion to increasing its investment; indeed, if it could turn back the clock, it would not make the past investments. However, since that happy alternative is not present, the company showing losses may decide that its best available policy is to introduce improvements and to expand. Even a bankrupt railroad, the receiver of which is striving to salvage as much as possible from an unfortunate venture, may nevertheless buy new equipment. In fact, such railroads have been good customers for Diesel engines and streamlined equipment—perhaps just as good customers as companies which could hope to show a positive profit from such uses of funds. One businessman has referred to this situation as a "negative" reason for expansion, meaning that expansion may be undertaken to minimize losses as well as to make positive profits. Thus the pressure of competition applies particularly to existing companies, be they profitable or not.

Likewise, the compelling force of overhead costs in creating a need for volume quite evidently applies especially to concerns that have already made commitments, and a still further compulsion upon existing companies is the pressure of owners and managers to utilize available funds in the established business.

The significance of these forces impinging upon going concerns is that they quite evidently do not appeal to *prospective* entrepreneurs or investors. These enterprisers are in a much

more strategic position than those who have already made a major commitment. If they cannot see a reasonable prospect of a rate of profit which is attractive in view of all the risks that are involved, they will not move. The established company may feel impelled to move anyway.

We can, therefore, expect a certain volume of business and even, in the case of some individual firms, a certain amount of expansion from such autonomous forces operating upon existing companies. But we cannot expect such forces to serve as a substitute for the positive incentives.

Viewing the matter broadly, we have at any time in this country a huge industrial and distributive plant and a large number of men who have committed themselves to operating it. In view of these commitments, the community as a whole or various blocs in it can—through price controls, wage policies that adversely affect cost-price relations, or onerous tax burdens and other pressures—reduce the attractiveness of enterprise without immediate disastrous effects. A certain volume of production will be maintained by these incentives. But in time, activity induced by such forces would decline (if for no other reason) because of the natural mortality of enterprises combined with a decline in the business birth rate. The presence of these forces working upon existing companies creates the danger that the public, and particularly our makers of public policy, may come to rely too much upon them. To some extent and for a time the momentum of going concerns may overcome retarding tendencies and thus hide from us the inevitability of the ultimate result. But we may be sure that the supply of enterprise, in whatever form, does in time respond to its rewards and will have its effects on employment and production.

While the effects of incentives upon prospective enterprisers and existing concerns are quite different, their effects upon large and small firms are very much the same. In both the small and the large firms, we have the incentives to meet and supply the current demand for goods; to expand in such ways as to keep pace with competitors; to increase profits in absolute terms through an increase in volume; to reduce costs and thereby improve profit margins or gain volume; and to insure stability

and security of the firm. The relative weights to be given these incentives, of course, differ widely among firms. For example, expansion may be more highly desired than stability among those concerns that are "on the make," but these firms are as likely to be big as small. Among the retailers of a town, all of whom are "small business," we find some who are dynamic and adventurous and others who are conservative; they are probably divided in about the same proportions as large manufacturers or large city department stores.

Moreover, the basic motives identified as contributing to the hedonistic calculation are, for the most part, the same. It might be considered that the desire for power is not so influential among small businessmen; but the closely related desire for independence and for "being my own boss," and the corresponding dislike for "interferences" seem, if anything, to be more marked with small businessmen than with large. Another possible exception may be that the influence of social obligations does not apply so closely in the case of small business as in big business, because the effects of the decisions of the small businessman will be less extensive and apparent. But while the small businessman will presumably not be influenced by the effect of his actions upon such great issues as the general price level, or the volume of employment or purchasing power, he is nevertheless closer to his local community and to his clientele; and he is apparently as much influenced by the obligations thus created as are the larger businesses in their correspondingly larger fields. The devotion to the job, demonstrated by many small retailers during the trying war period, is an evidence of this fact.

Efforts have been made by certain political leaders to draw a sharp distinction between big and small business and to make political capital out of the supposed conflict of interest between the two. However, the fact seems to be, not only that the incentives of the two are similar, as we have seen, but that their interests are also closely allied. In our closely woven economy, it is hardly conceivable that one of these groups can prosper at the expense of the other. On the contrary, their fortunes very largely rise and decline together. There are a number of reasons for this. One is the fact that many small firms exist in order to

sell goods to large firms. For example, one large automobile company reports that it purchases materials, supplies, and services from over 13,000 other business units and that the value of these purchases runs currently to over $1½ billion. On the other hand, this same company distributes its varied line of products through some 100,000 sales outlets, most of which are small businesses. Nor do these statements take into account the thousands of business concerns, restaurants, retail stores, and others which serve the employees of the large business. This interdependence, in addition to the similarity of objectives and points of view of the large and small businesses, serves to explain why the positions of the two on large political-economic issues are very similar. Indeed, the representatives of big business may grumble about the many types of government regulations and the interference of labor unions with management independence, but their opposition is mild compared to the bitter invective which the small independent businessman vents upon them. Despite some points of opposition (such as the small retailers' demands for protection from the competition of chain stores), there is, in the relations of business to the state, an almost instinctive allegiance between businessmen of all kinds that is deeper than their differences. This fact has been demonstrated when political leaders have unsuccessfully tried to organize a political bloc of small businessmen on the ground of the supposed antipathy of their interests to big business. The part of statesmanship would seem to be to recognize that American business enterprise, in many and important ways, constitutes a complex unit comprising businessmen of all sizes and particular lines of activity, and that this fact is basically much more important than any of the conflicts of interests which may be discovered and stimulated.

In summary of these similar and contrasting incentives and forces working upon new businesses (which are frequently, but not always, small) on the one side, and the old businesses, on the other, it appears that there is greater need for the community to give special attention to the needs of the former group because the momentum of past commitments is not working upon that group. The incipient enterprise must have positive attractions if it is to come into being. This is not to say, how-

ever, that the one group requires different treatment from the other, for generally a tonic that is good for one is also good for the other. The difference is mainly that the effect of an unfavorable economic environment will be more promptly shown in the case of new and potential concerns than in the case of old and well established ones. The older ones (and the larger ones) may, in the face of unfavorable taxation and other discouraging features of the economic-political environment, continue to expand for some time, but in the long run the results will be much the same in one case as in the other.

## ADVANTAGES OF SIZE AND AGE

Although the points of similarity of firms in these several categories are striking, there are advantages of large size and of established position. The large manufacturing concern, for example, commonly produces a more extensive line of goods than does the small firm. The effect of the possible loss from a new venture upon the general fortunes of the company is thereby reduced. A large multiline company might well afford to undertake the production of a single new product because the possible losses could readily be absorbed in the general volume of business; whereas a new concern, established for the production of that one thing, might find the risk too great to be undertaken. Our tax system also presents a similar advantage to the established company because such a company can deduct possible losses in a particular venture from the profits of the many other ventures which it is carrying on.

Moreover, there is the obvious fact that existing companies have established business contacts providing them with sources of supplies and established markets. They also ordinarily have an existing goodwill. In business, as in other forms of endeavor, it is easier to maintain an established position than it is to establish a new position. Another advantage, important in some cases, is the ownership of patents by existing companies or the existence of licenses which tend to reinforce the position of the established concern. In recent years the industrial research departments of established companies provide, not only the new ideas upon which expansion may be based, but also the equip-

ment and the organization for exploiting new ideas that may be generally available.

A further advantage of the existing company, particularly the large one, is that it may not need to go to the capital markets at all; and if it does need to do so, it has ready access to them. The new enterpriser will surely have to have new capital; and if he is small, as new enterprisers commonly are, the mechanism for securing new funds is frequently inadequate. This does not imply that the funds are not available, although that may be true because of the risk of the venture, but rather it refers to the mechanism for bringing investors and promoters together.

An advantage, then, of the large concern (and an even greater advantage of the large old firm) is the more ready access which the firm has to capital funds that may be required for expansion—an advantage arising from the fact that our financial markets are not geared to providing funds in the small amounts needed by small business. The corresponding disadvantage of small firms, which has often been noted, is partially offset by the fact that substantial proportions of the capital requirements of manufacturing and distributing concerns, both large and small, are met from the earnings of the business itself; and, given the assumption that the concern is successful and profitable, this source of funds apparently serves the small company as well as it does the large one. As to current bank loans, the disadvantage of the small firm does not seem to be pronounced. The problem is one of equity capital; and efforts being made to overcome the technical difficulties of freeing the channels between the suppliers of funds and deserving businessmen who would use them should, of course, be encouraged.

Another undoubted advantage of large concerns is the range of research which they are able to undertake. While the value of sheer Yankee ingenuity is still substantial and probably greater than many people assume, it is undoubtedly true that many of our fruitful industrial discoveries and improvements in technique are made by organized industrial laboratories. These quite evidently can be better supported by large organizations than by small ones.

Related to this subject is the effect of discoveries upon the

establishment of new concerns. It is sometimes assumed that new ideas, especially as to products, will lead to the forming of new companies to exploit them. There may be some indirect effect of that kind; but the evidence of the last two decades seems to be that new products have been produced, during that period, by existing companies rather than by new companies formed for the purpose. For example, the production of six products now well known but unknown at the close of World War I is, at the present time, very largely in the hands of companies that existed before the new product came into being. Six of such products are: fluorescent light tubes, radios, mechanical refrigerators, electric razors, air-conditioning equipment, and plastics. If we take a list of the fifty companies which are the leading producers in these lines and look into their past histories, we find that only three out of the fifty were established for the purpose of producing the new product. For example, of the twelve leading producers of mechanical refrigerators, only one was established to produce that product; of the ten leading producers of plastics, not one was established for that purpose, but all were in existence and, for the most part, large and well-established concerns prior to the introduction of this new line.[2] The figures are not conclusive as to who was responsible for the initial development, and, of course, the business of the initiator may have been absorbed by the present producers; but the figures do seem to indicate that lately companies have not, characteristically, entered and remained in the industrial field as a result of inventions. It would be interesting to inquire whether this has always been true, and if not, what has caused the change. For example, we recall that the introduction of prepared breakfast cereals at about the turn of the century did result in the establishment of a number of new companies, many of which have remained in the field. The early history of the automobile industry presents a similar picture.

These distinctions between established concerns and new concerns have been noted by several executives of large companies. When asked about their attitude toward expansion and the effect of possible deterrents (the tax system, for example), they

[2] *Ibid.*, pp. 45 ff.

have frankly stated that there are competitive and other pressures for expansion impinging upon them which might lead them to undertake new ventures in spite of a prospect of very low profits, or possibly, of no direct profit at all. Their view is that they simply cannot afford not to adopt new methods or produce new types of products; for if they fail to do so, they would be endangering their competitive position. They have the necessary reserves and financial resources with which to undertake such moves, and any individual move of this kind would represent but a small part of their total venture; and, in any event, if they should lose money on the new venture, they can deduct that loss from profits for income tax purposes. These same men have volunteered the suggestion, however, that if they were in the position of a small or prospective businessman, they would not undertake the venture in the face of the existing tax system, and other obstacles.

## ADVANTAGES OF NEW AND SMALL FIRMS

Lest all this should be interpreted as representing a hopelessly discouraging prospect for the establishment and growth of new companies, the high rate of business births noted at the beginning of this chapter should be recalled, and it should also be recognized that a new enterpriser does have certain positive advantages. There is the advantage of a fresh approach to his problems. In some industries, there is a real advantage in being able to select a site for the establishment, whether it is to be a distributing or manufacturing plant. An old company is committed and may have to make the best of a bad location. Furthermore, the new enterprise is free from certain accumulated obligations that old companies have assumed, such as obligations to old employees. These may be represented by formal contracts, or they may merely have the force of moral and humanitarian considerations. For such reasons individuals may be continued on the payroll when they have passed their peak of effectiveness. Commendable as these policies are, they do involve costs which new firms do not have to bear.

Also, the small business enjoys greater freedom of action. In the first place, it may have, as is often alleged, greater flexi-

bility. Certain men who have had considerable experience with small businesses have said that they are more concerned about the competition of aggressive "little fellows" in their fields than with the competition of the "lumbering" industrial giants. Second, the little business is less subject to controls by labor unions and administrative bodies, and it frequently enjoys specific exemptions from regulatory legislation. As one of these little businessmen said: "The small fish slip through the net." It does seem to be true that small firms can escape notice for some practices which, if engaged in by the giants, would surely draw the fire of the Anti-trust Division, the Federal Trade Commission, or labor unions. Third, a small firm can feel freer to change its prices or its policy at will without fear of disrupting the market or starting a competitive war. Several instances come to mind in which the dominant concern or concerns of an industry have not reacted to a degree of price competition from the small fry which, if indulged in by more important producers, would have called forth prompt reaction. Fourth, the large firm is more subject to the force of public opinion than is the small local firm. This sensitivity of large firms to their "public relations" is only partly explained by the prospect of prosecution or regulation. Bigness carries with it power, but it also imposes limitations on freedom of action. An officer of one nationally prominent company in the food field remarked (he was speaking particularly of prices): "Every action we take is under the spot light of publicity and is conditioned by its probable effect on public opinion."

## CONCLUSION

Large and well-established concerns have certain important economic values, chiefly in efficiency and in their contributions to progress through research and the possession of resources with which to put the results of research and product development into effect. But the new company, which is usually small, at least in relation to others in its industry, also has values which are essential to an expanding and dynamic economy. Moreover, variety in our economy is to be desired as a basis for economic freedom of enterprisers, investors, and workers.

The incentives for economic expansion through the further

growth of large established firms appear more numerous and potent than those applying to the founding of new ones. For this reason, we should, in our public policy, be particularly solicitous about the encouragement of new or incipient enterprises. This encouragement may, to some extent, call for special aids to new firms, but a more promising approach appears to be to create an environment favorable to the making of future commitments and the assumption of risk by enterprisers generally. For, while the problem of encouraging economic expansion through the birth and growth of small companies has some special features that are worthy of attention, the features which it holds in common with business enterprise in general are more fundamental and practically important.

The removal of some of the deterrents to business expansion in general will, in fact, give relatively greater aid to the new enterprise than to the established one. For example, we have mentioned that the deterring effect of heavy corporation taxes acts as a greater deterrent to the small and new business than to the large and established concern. Hence, any reform designed to remove that deterrent would be relatively more helpful to the new enterprise than to the old—and without any discriminatory treatment in favor of the new concern. Also, any improvement that might be made in providing better access to capital funds probably would be of relatively greater benefit to the small and new companies. Thus legislative reforms designed for the encouragement of all enterprise might well be adequate for this particular form of expansion; and, in any event, they should be the first steps toward encouraging new and small business.

It is a problem which deserves the serious attention of all people (whether in the small or large business class) who are interested in the preservation and encouragement of free enterprise. Both from the point of view of the political and social values involved and that of economic effectiveness, we very much need in this country to encourage more men to establish businesses of their own, and thereby to provide employment instead of merely seeking it.

# 11

## *PRODUCTION AND PRODUCTIVITY*

How well we, the people of this country, can live in a material sense depends upon how much we produce of those things we desire. How much we produce depends upon how effectively we work and how much we work at producing those things. Upon these two propositions hangs the whole law of economic well-being and economic progress.

The purpose of this chapter is to inquire into the specific factors in a private enterprise system that will determine the effectiveness of our work and the amount of our work.

### AMOUNT OF WORK

When we say that one of the factors determining the amount of production is how much we work, we refer to the sheer amount of time that people devote to production. Broadly speaking, the amount of work is determined, first, by the number of people who customarily work; second, by the amount of time which these workers devote to work, when they are employed; and, third, by the extent to which the "working" population is kept employed. In the first case, we are referring to those who commonly regard themselves as workers. They can be said to constitute the working population—the labor force, in other words—by which we mean more precisely the number who are able and desirous of working. The second factor is the amount of time which the individuals of the working population customarily devote to work, that is, the length of the working day and week. The third factor, regularity of work, is largely, though not entirely, dependent upon the opportunities which the system offers at any time for employment. These three factors could be quantitatively expressed. For example, it would be possible to say that in this country there are *X* number of people

who commonly regard themselves as workers; that they would normally work an average of $Y$ number of hours in the course of a year; and that a measurable proportion of those workers, which we could call $Z$, were in fact employed. The product of $X$, $Y$, and $Z$ would give us the total number of man-hours (bearing in mind hereafter that this term also includes the work of women) which the country devotes to production in the course of a year.

The working population of various countries differs widely. Although it is difficult to get comparable statistics, it is a matter of common observation that in countries of low economic development a very high proportion of the people find it necessary to work. In countries like China and India and even some of the less developed European countries, even very young children must participate in the actual business of earning a living; whereas in more advanced countries, such as the United States, commencement of employment is much longer deferred. Likewise, old people and those whom we would regard as physically disabled are necessarily employed; and in most of these countries, large numbers of women are engaged in actual agricultural production.

The age at which people start work has steadily declined in the United States until child labor (employment of persons under fifteen) has virtually disappeared. In 1900, 26 per cent of boys between the ages of ten and fifteen were classified as gainfully employed. That percentage declined to 21.7 in 1910, 16.8 in 1920, and 6.4 in 1930; by 1940, although precise figures are not available, it is agreed that child labor had become almost nonexistent. The trend for girls between ten and fifteen years of age followed much the same course, with about 10 per cent employed in 1900 and virtually none employed by 1940.[1] Moreover, the trend has not stopped at the age of fifteen. Figures are not available for the group between fifteen and twenty-five; but it is quite clear from high-school enrollments and the attendance at

[1] J. F. Dewhurst and Associates, *America's Needs and Resources* (New York: Twentieth Century Fund, 1947), Table 183, p. 544. Many of the data used in this chapter and not specifically cited are drawn from this invaluable quantitative survey of the American economy.

colleges and professional schools that the proportion of persons, even up to the early or mid-twenties, who can be excused from immediately productive employment has rapidly increased in recent decades and probably represents a higher proportion of the population than has ever been attained in any country.

A bit of evidence on this point is provided by the number of university students per 1,000 of the population in several countries (see Table 1). The outstanding position of the United States is apparent, and it should be noted that these comparisons were for a period before the present federal subsidies to veterans and

TABLE 1*

NUMBER OF UNIVERSITY STUDENTS PER 1,000 OF POPULATION

| | | |
|---|---|---|
| 1930 | United States | 7.88 |
| 1932 | England and Wales | 1.2 |
| 1932 | Germany | 1.9 |
| 1932 | France | 1.8 |
| 1932 | Holland | 1.6 |
| 1932 | Sweden | 1.8 |
| 1932 | Spain | 1.5 |
| 1932 | Norway | 1.6 |
| 1932 | Austria | 3.6 |
| 1932 | Belgium | 1.3 |
| 1932 | Italy | 1.2 |
| 1932 | Czechoslovakia | 2.3 |
| 1932 | Hungary | 1.8 |
| 1932 | Greece | 1.2 |

* Colin Clark, *Conditions of Economic Progress* (London: Macmillan & Co., Ltd., 1940), p. 238.

the phenomenal increase in university enrollments in the years following World War II. The contrast between the United States and the other countries would no doubt be still greater today.

This large proportion of the population withheld from the labor force represents a considerable reduction in the *amount* of work that the population can perform. If this reduced amount of work is not to result in a reduced national income, it must be offset by a corresponding increase of effectiveness of work. It is believed that protracted training does enhance later effectiveness and thus does not reduce national productivity. On the other hand, extended education is a fruit of high productivity. Only a productive country can afford to defer the beginning of work to

as late an age as we have reached in this country. Thus, we have the situation that only a productive country can afford to give a long period of training and that the long period of training is in turn one of the factors creating that productivity. (This, incidentally, is not an unusual relationship in economics. Similarly, only a productive country can afford to devote a large amount of its time to producing capital goods; but when those capital goods are produced and used, they in turn increase the productivity. It is a cumulative process suggested by the adage that "to him who hath shall be given.")

Likewise, the proportion of old people who are included in the working population has steadily declined from 1890, when about 7 out of 10 old men (defined arbitrarily as over sixty-five) were employed, to 1940, when it was about 4 out of 10. The proportion of employed women in this age group has also declined, although it never was as high as 1 out of 10, and the decline has proceeded to approximately 1 out of 20. The early retirement of old people and the late starting to work of young people, then, have a significant effect upon the size of our working force; and with the changing age distribution of the population, which is tending toward a larger proportion of old people, the significance of these factors will surely increase. When we retire from active production at an earlier age than is physically necessary, we no doubt reduce the total amount of production; and there is not the corresponding argument for such a policy on the ground of increased effectiveness that exists at the other end of the life period. The justification must be on the grounds of a deliberate choice that we prefer release from the burden of work to the additional amount of goods and services that might have been provided. There is a general sentiment in this country that a movement in this direction is highly sensible and will contribute to the sum of human happiness. It is merely, however, a confusion of the issue and a misrepresentation to argue, as it was argued by some people during the 1930's, that somehow the economic standard of living is going to be raised by such a policy. The policy must stand on its own feet. It cannot be and does not need to be supported by fallacious economics.

When we remarked in the previous paragraphs that the

people of the United States choose a certain policy regarding the amount of work they do, we were speaking figuratively, to a certain extent, for, of course, not all people will arrive at the same conclusions. In a good society individuals should be free, as much as possible, to make those decisions for themselves, and if the decisions are so made we believe that the combination of those decisions will come closer to approximating wise national policy than if they are made by someone for the whole group; even, it may be added, if that someone represents a 51 per cent majority. This should be our ideal. That it cannot be completely attained is clear when we recognize that people work in groups, and that if one chooses to be in an industry which works 8 hours a day, then one must conform to that pattern. Nevertheless, the ideals should be kept in mind, and we will be fortunate if there is enough variety of occupation and terms of employment to enable people to choose freely between them.

The most important of these conditions of employment is the wage; and in this respect, there has been a trend away from variety and toward standardization. This shows itself in the standard union wage for many trades and occupations and in the establishment by law of minimum wages. Workers are not equal in ability, stamina, and other respects. Among other variations, the youngest workers and the oldest ones are, in many lines, not so effective as those between these extremes. They could, however, add to our productive power and, in many cases, would do so if they could be employed at wages commensurate to their productivity. Employment on these terms is prohibited or discouraged by the standard and minimum wage. Thus the reduction of the amount of work through a shortening of the working period of life has not come about altogether from a voluntary choice nor because we are now sufficiently prosperous to afford that reduction. Like many other choices in our society, this one has become less free, partly because of the natural requirements of some lines of industry, but partly because of rules and policies adopted by organized groups, or largely through their influence, imposed by the government.

The effect of the trends mentioned so far has been toward diminishing the amount of work; but, as a matter of fact, the size

of the labor force in this country increased more rapidly than did the population up to 1910, when it was about 40 per cent of the population, and since that time it has shown little change.[2] The constancy of the proportion of our people in the labor force in recent years, in the face of the negative trends just mentioned, has been maintained by the offsetting fact of the increased employment of women. The employment of women in recent decades has increased at a moderate rate. In 1900, 21 per cent of the women between the ages of sixteen and sixty-four were classified as gainfully occupied. In 1910 there were 25 per cent employed; in 1920, 25.5 per cent; in 1930, 28.8 per cent; and, while strictly comparable figures are not available, the evidence is that the percentage has increased to the present time. This increased employment of women, although it has proceeded at a much lower rate than the decreased employment of the other groups, has offset the other trends because women represent such a large part of the population.

In the next decade or two, we may expect all of these trends to continue and may reasonably anticipate, therefore, that about 40 per cent of the population will be workers.[3]

The second factor which helps determine the amount of production is the amount of time devoted to work. This is determined by the length of the average workday and work week and the length and frequency of vacations. The best tangible figure to indicate this trend is in the length of the work week. The work week has declined steadily from around 69 hours in 1860 to 43 hours in 1940.[4]

This trend is commonly regarded as representing a social gain. So it is, if we regard it as desirable to have more leisure, even at the expense of somewhat smaller amounts of goods and services. As a country advances in the efficiency of its production, it can very sensibly take part of the dividend resulting from that improvement in the form of leisure. There are those who will argue that the shorter workday, the shorter work week, and the augmented vacations increase output. It should be noted that,

[2] Dewhurst, *op. cit.*, Table 181, col. 5, p. 542.

[3] *Ibid.*, Table B, p. 777, and Table 9, p. 37. This study forecasts the labor force of 1960 at 63.4 million and population at 155 million, a proportion of about 41 per cent.

[4] *Ibid.*, Table 3, p.23. (A weighted average of agricultural and nonagricultural labor.)

in order to support this argument, it must be shown that the increased effectiveness *caused by* the increased leisure is more than enough to offset the reduced number of hours. Even by this strict test, the argument is no doubt valid up to a certain point and in certain industries. Perhaps it is especially true under the exacting standards of modern manufacturing. But certainly a people cannot continue indefinitely to increase output by working fewer hours, for the gain and efficiency per man-hour will sooner or later be overtaken by the countereffect of reduced hours. We have probably reached that stage in most industries; and from this point on, a shortening of hours must be justified, not on the ground that it is going to improve our material well-being, but on the value of the leisure for its own sake.

No one can judge how far a country should go in these directions. At least no one can do so unless he has the presumption to decide for other people how they should direct their lives. (There are, incidentally, some people who are apparently willing to assume that godlike role.) But while final advice cannot be given on this point, it is the responsibility of economists to point out that these devices represent no magic formula by which (all other things being equal) we can have more leisure and more products which are the fruits of work, not of leisure, and that, therefore, the choice should be made deliberately and on grounds which the individuals of the country consider will yield them the greatest satisfactions. In particular, doctrines which hold that there is only a certain amount of work to be done and that we are, therefore, compelled to take more leisure —either in an orderly or disorganized fashion—should be rejected. At the very least, one can say that if that situation appears to exist, the remedy should be sought in a better co-ordination of our activities and in a more actively expanding economy.

The third factor determining the amount of work is the opportunity for employment. In this case in particular, the free decisions of individuals are at times limited by depressed conditions of trade and industry; and, primarily because those conditions limit the freedom of choice of individuals to work more or less, the maintenance of a high level of employment has become one of our most serious social problems. More accurately,

the goal should be called the maintenance of a high level of *opportunities* for employment.

Whether or not the perverse forces that cause involuntary unemployment are becoming more frequent or more pronounced is a difficult question because of the different meanings that may be attached to the terms. For example, it is one thing to ask whether the proportion of normally employed persons who were thrown out of work by some earlier depression was greater or less than in the depression of the 1930's; it is another question whether the proportion of our population affected by the earlier depression was greater or less in the same period. One reason the two questions are not the same is that the proportion of our people who gain their living by working for themselves (as farmers) and by working for others (as wage earners) has changed. Thus, if in an earlier period we were predominantly a self-employed people and are now predominantly an employed people, then a decline of, say, 20 per cent in employment, in the narrow sense of holding a job, would present a more serious national problem now than then. This trend has taken place; and, therefore, recurring periods of unemployment are a more serious threat to national well-being.

Another difference between the two questions arises from the fact that even the self-employed are now producing for the market, whereas in earlier periods more of them were producing for their own consumption. Moreover, the enterprises which hire workers are today more interdependent, since to a greater extent they are selling their products to other producers. Thus, a depression in trade is a more serious problem because it affects a larger proportion of our people and because it can spread like an epidemic, hitting the rich and the poor, the mighty and the weak, alike.

The impact of the forces of depression are further aggravated by some conditions of our own making. Among these are ineptly conceived and administered relief measures and a decline in the mobility of labor between occupations. There is a tendency to consider a bricklayer who cannot find employment as a bricklayer as "unemployed" although other less desirable employment might be available. Moreover, in many cases other em-

ployment may not, in fact, be available because of seniority and union rules, including again the standard wage in those other lines of work.

Regarding the proportion of the normally employed (hired) workers thrown out of work by such depressions in recent years, compared to the past and the frequency of those disasters, the evidence is not clear. One authority on business cycles concludes that, at least up to 1913, no trend was discernible and that the unemployment during the thirties can be accounted for on grounds that have nothing to do with long-run tendencies inherent in the capitalistic mechanism.[5]

Nevertheless, an important factor in our modern society which determines how much we work is the supply of opportunities to work. It is our view that the supply of these job opportunities is largely a matter of the supply of enterprise, that is, of businessmen striving to start or expand businesses. This supply of enterprise will be influenced, of course, by other factors; but these other factors gain relevance and effect only as they influence this supply of enterprise. (The uninitiated reader should perhaps be warned that this view of the central position of the enterpriser is not shared by all economists.)

## EFFECTIVENESS OF WORK

What determines the effectiveness of our work? As we used the term in the opening paragraph of this chapter, we intend to give it a very broad meaning. The effectiveness of the work of a country includes the success with which it is directed to the production of desired goods rather than unwanted goods. If our aim is the improved material well-being of a country, it is necessary that our work be directed to producing the things and services which will improve that material well-being. There are many instances in modern and earlier times of the direction of effort to other ends. One cannot say that these ends were unwise, but often they were fruitless as to the end which we have in mind here. For example, if a people desire to improve their material well-being, but their efforts are directed by the gov-

[5] Cf. Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Bros., 1947), pp. 69–70. Also his *Business Cycles*, *passim*.

ernment to unnecessary preparations for war, then we would say that the effort put forth, even though of high quality and high quantity, was nevertheless ineffective in the sense of being badly directed. Likewise, if we are looking to the general well-being of a country and if the energies of that country are directed too much to the production of luxury items which would be used by only a small part of the population, as was the case in France before the Revolution, then again the energies have been badly directed and relatively ineffective.

Even if the intention is to produce those things and in the relative proportions that the people generally want, there is ample opportunity for error. That is true in any kind of a society. In a free enterprise society, the strongest incentives are placed upon hundreds of thousands of individual decision centers to avoid such errors. The men occupying those strategic points have, by and large, gained them by the process of competition and survival. The rewards for being right are high; the penalties for being wrong are both impersonal and heavy. Nevertheless, with all the effort and good intentions which the system of rewards and penalties bring forth, the problem of judging in advance precisely what goods will be wanted, in what quantities, where, and when—for millions of consumers who are free to choose and free to change their minds—is obviously a difficult one. All the techniques of measuring and forecasting market demand which are being developed in this country are helpful; and in so far as they enable enterprisers to solve this problem, they contribute to the effectiveness of our work.

Assuming, then, that the energies of the country are directed to the production of those things that the people of the country desire, the effectiveness of the efforts will depend upon a number of factors: for one, upon the quality of the workers—their general health, physical strength, and intelligence. In this respect, modern industry places increasing importance upon health, intelligence, and education rather than upon sheer physical strength. As to basic intelligence, there is no clear evidence of the superiority of one nationality or race over another; and, in any event, there is not very much that can be done about it, at least without embarking upon planned eugenics to

an extent which would be incompatible with a free society. But as to health and education, a country can do a great deal by way of improving the effectiveness of its people.

One of the most important factors influencing the effectiveness of work in modern times is the quantity of capital employed. Capital can be regarded in several different ways, and it has a number of aspects. Of most significance for us is the aspect of capital as a sum of tangible reproducible goods used for the furtherance of production. This includes all those goods in the hands of producers and distributors. Also, since some goods owned by consumers yield their utilities only over a long period of time, they can be regarded as a part of the national capital. Since consumer goods vary so widely in this respect, it is necessary to draw an arbitrary line. That line is commonly drawn to include, as "capital" residential buildings but not other consumer goods.

There are three main categories of these capital goods. First, there are the tools, equipment, and plant which facilitate and extend the physical output of workers. In a simple economy, this stock of facilitating instruments consisted of such simple implements as shovels and pickaxes. In our modern world, it consists of the railroads and other means of transportation, power plants, industrial plants of the country, elaborate machine tools and equipment, and the buildings, animals, tractors, and other implements used in agricultural production. Second, there are the supplies of materials and goods used in the process of production and distribution—the inventories of suppliers, manufacturers, and distributors. The third category is residential construction, which can be disregarded for the moment.

While all these categories are of importance in considering the United States today as a productive unit, the one which most clearly distinguishes our age from earlier periods and which distinguishes the United States from many other countries in the world is capital goods in the first category—the tools and equipment, using the terms in a broad sense. In manufacturing industry in the United States, for example, there is over $8,000 worth of these capital goods for every worker. This figure has increased steadily and rapidly throughout most of our history. (Certain

changes in this trend will be noted later.) In the long course of our history the figure has advanced from $800 in the year 1860 to over $8,000 in the year 1929, and it is estimated to be at still higher levels at the present.[6] This ratio of investment in plant and equipment per worker is higher than that of any other country in the world, and it is much higher than ever before attained in the history of the world. Carl Snyder has said: "This and this alone has made it possible for the average manufacturer in the United States to turn out nearly twice as much in goods per worker as that in any other country in the world."[7] While

TABLE 2*

NONHUMAN HORSEPOWER HOURS
(In Billions)

| | *Total* | *Per Worker* |
|---|---|---|
| 1860 | 22 | .... |
| 1880 | 34 | 1,960 |
| 1900 | 74 | 2,550 |
| 1920 | 186 | 4,148 |
| 1940 | 279 | 5,236 |
| 1944 | 360 | 7,000 |

* J. F. Dewhurst and Associates, *America's Needs and Resources* (New York: Twentieth Century Fund, 1947), Table B, p. 787, and Table 181, p. 542); and *Statistical Abstract of the United States, 1944–45*, p. 127.

the exclusive importance attached to this factor may be an exaggeration, it is surely one of the major factors. Over a period of time and in comparing the countries of the world, this ratio no doubt contributes more to the man-hour productivity of a country than any other *tangible* factor. Moreover, since its significance and importance are not affected by the type of social or economic system under which a country may choose to operate, it becomes one of the hard realities to which any country must look if it is to advance the man-hour productivity, and thus the economic well-being of that country.

Another indication of the increased use of capital is in the mechanization of industry which is indicated by the steady

[6] Economic Principles Commission of the National Association of Manufacturers, *The American Individual Enterprise System* (New York: McGraw-Hill Book Co., Inc., 1947), p. 876.

[7] Carl Snyder, *Capitalism the Creator* (New York: Macmillan Co., 1940), p. 237.

growth of the use of mechanical power. In the earlier years, this energy was largely supplied by work animals; in later years, predominately by water power, coal, and oil. In terms of nonhuman horsepower hours employed in this country in total and per worker, the increase has been as shown in Table 2 (p. 205).

This index indicates the extent to which the sheer manpower engaged in mechanical and agricultural production is multiplied. Still another index of this same trend is given below, showing the proportion of energy employed in this country in the form of human energy, animal energy, and mechanical energy resulting from the use of mineral fuels, coal, oil, etc.:

PROPORTION OF ENERGY (IN PER CENT)*

| *Year* | *Mechanical* | *Human* | *Animal* |
|---|---|---|---|
| 1850 | 6 | 15 | 79 |
| 1900 | 38 | 10 | 52 |
| 1940 | 90 | 4 | 6 |

* Dewhurst *et al.*, *op. cit.*, p. 787.

In short, relative to output and to the number of workers, the human energy employed since 1850 was steadily declining. This fact, of course, increases output *per man*, although it may have the opposite effect in output per unit of capital goods or mechanical energy.

We must observe, however, that this equipment is not the only category of capital; and, if we consider the total supply of the United States, measured in values, there are some evidences that the trend in the last decade and a half has not been encouraging. It is estimated that the reproducible capital wealth of the country had advanced in value from an insignificant figure in colonial times to some $300 billion just before the war. Thus, one can say that roughly the prewar capital stock of the country was about three times the national income. This growth of capital had proceeded at a remarkably high rate in the last half-century. The estimates at ten-year intervals are shown in Table 3.

Two conclusions are apparent: first that the capital accumulation for fifty years ending in 1929 had proceeded at an accelerated rate, in terms of constant value dollars until the decade of the twenties, when it reached $70 billion. But a

startling fact is that in the decade ending in 1939 the advance was negligible; and after the year 1929, in which there was a substantial gain, the rest of the decade showed a loss. These figures include publicly owned capital goods, government buildings, government-owned power plants, and residential buildings. If these elements are excluded and we confine ourselves to

TABLE 3*

REPRODUCIBLE WEALTH OTHER THAN HOUSEHOLD
(1929 Prices, in Billions of Dollars)

| *Date* | *Total* | *Increase in the Decade* |
|---|---|---|
| January 1, 1879.................. | 35.9 | ... |
| January 1, 1889.................. | 62.0 | 26.1 |
| January 1, 1899.................. | 101.2 | 39.1 |
| January 1, 1909.................. | 151.8 | 50.6 |
| January 1, 1919.................. | 217.7 | 65.9 |
| January 1, 1929.................. | 287.9 | 70.2 |
| January 1, 1939.................. | 298.3 | 8.4† |

* See C. Reinold Noyes, "The Prospect for Economic Growth," *American Economic Review*, March, 1947, a paper which utilizes the data of Simon Kuznets and particularly his *National Products since 1869* (New York: National Bureau of Economic Research, 1946). For further, although not strictly comparable data up to 1948, see *Cleveland Trust Company Business Bulletin*, May 15, 1948.

† 10.5 in 1929 alone.

private business capital, it is estimated that there was an actual decline for the whole decade.

The trend was described by Professor Slichter in 1948 as follows:

> In the fifty years preceding 1929 the country annually produced about $1.75 of capital for every dollar of plant and equipment which wore out or became obsolete, so that the plant and equipment of the country was growing rapidly. In the last nineteen years, however, the country has produced only about $1.14 of new capital per year for every dollar of plant and equipment which wore out, with the result that at the end of 1947 the industrial plant of the country represented less than 8 per cent more capital than at the beginning of 1929.[8]

This reversal raises a serious question as to what the trend will be once the immediate stimulus of the war has passed. But it is in place here to point to the high importance which a large

[8] Sumner H. Slichter, "Are Profits Too High?" *Atlantic Monthly*, July, 1948, p. 32.

and growing supply of capital employed in production has had in advancing our rate of productivity and to urge that we cannot afford to neglect any policies which will speedily re-establish that trend in its old course.

A paradox is presented by the fact that the flow of goods to consumers between 1929 and 1941 increased about 19 per cent, and there has apparently been an increase since 1941.[9] How could this take place in the face of declining capital? Five explanations can be suggested. First, that the improvement in the measurable standard of living between 1929 and 1941 was less than one-half the improvement between 1919 and 1929. Second, that the actual improvement (not so readily measured) was accounted for by the improvement in the quality and effectiveness of goods—for example, better automobiles, the production of which did not necessarily involve more materials or more equipment. Third, that the improved standard of living consisted, to an increased degree, in the purchase of perishables and in the consumption of services and, to a decreased extent, in the purchase of semidurable and durable goods, the production of which demands larger amounts of capital. Fourth, that under the impact of a high level of production in recent years, the capital equipment of the country was kept more highly employed. The effect of this fact would obviously be to increase the flow of consumers goods relative to the amount of capital. It should be noted that this factor is of temporary force, for full use of the capital resources has been attained and no further gains on this account can be expected. Fifth, we may have learned to use a given amount of capital (in value terms) more effectively. For one thing, the effectiveness of equipment may have increased, relative to the dollar value of it. For example, a $5,000 machine tool in 1925 may have been displaced by a $2,500 tool in 1940 which was actually more productive than the earlier one. This factor, the quality of capital goods, is another one contributing to man-hour productivity. Moreover, another aspect of improved use of capital, which it is too early to evaluate, is that we may have devised ways of supplying the

[9] C. Reinold Noyes, "The Prospect for Economic Growth," *American Economic Review*, March, 1947, p. 17.

country with a given flow of consumer goods with a smaller stock of inventories. From the point of view of marketing, one can visualize the economy of the country as made up of producing centers with an elaborate system of pipe lines and reservoirs running down to the homes of individual consumers. If we could devise a method by which the amount held in these reservoirs were reduced and the rate of flow through the pipe lines was increased, that would have the effect of economizing in capital represented by inventories. This surely was done during wartime, but at the expense of frequent and annoying shortages in the consumer markets. Whether we can and will continue to provide a given flow of goods to consumers with smaller inventories in peacetime is a question still to be answered.

The factor of the quality or effectiveness of capital is also a major factor in the long-run determination of productivity. Indeed, we have just now cited it as one explanation of the continued flow of consumer goods in the face of a declining quantity of capital. One country may be less effective than another which has the same amount of capital goods, the difference depending upon the effectiveness of the machines and other capital goods. For example, the effectiveness of the American industrial society compared to that of Britain depends not merely upon the relative *amount* of capital; it is also enhanced by the fact that our capital goods are more quickly replaced by new ones and that we, therefore, have more up-to-date equipment. Some of the textile mills in England are said to be employing equipment of a type which has long since been discarded in this country. The concepts of individual businesses concerning obsolescence and their policies in replacing the old equipment with new have an obvious bearing upon this quality of capital goods.

Another factor determining the effectiveness of our work is the quality of management. The term refers to efficiency in directing the flow of materials and the co-ordination of the activities of the workers. The adoption, for example, of so-called "scientific management" and the continuous and serious study of means of improving efficiency will contribute to this effectiveness of management. This quality of management will also be enhanced if the superior brains and abilities of the country are

directed into this line. It seems clear that a country which in the allocation of economic rewards and prestige and other rewards gives a relatively low place to management is not likely to attain this important requisite of effectiveness. The United States has been fortunate in that it has taken the problem of management seriously, and consequently it has attracted high grade abilities to that job. It has also developed its schools of technology and business more highly than any other country in the world rather than proceeding on the assumption that ability in management will emerge without any conscious effort to encourage it. One of the causes of the economic difficulties which Great Britain has progressively encountered in recent decades may possibly be the rather low social position accorded in the past to success in trade and industry and the failure of higher education to recognize the need for a serious study of business. The "nation of shopkeepers" has in this latter respect been singularly complacent about its shopkeeping.

Another factor bearing upon effectiveness of work is the extent of division of labor. The principle that effectiveness will be increased if individuals specialize in making certain things is, of course, well recognized. The principle, however, is broader than is sometimes assumed. For example, the automobile industry consists of a great complex of small enterprises, each of which performs only a small part in the production of a finished car. Even in the manufacture of a shackle bolt, several different enterprises may be involved, one of which, for example, does nothing but drill two or three holes in the bolt.

A different form of division of labor exists between regions and countries. The possibility of utilizing this principle of division of labor rests, of course, upon the possibilities of trade. A country, therefore, which has a large free-trade area and in which there is sufficient mobility of capital and labor to enable those factors to locate most effectively is likely, all other things being equal, to be more highly productive than a country in which a similar area is broken up by trade barriers imposed by governments and high costs of transportation, or by lethargy on the part of its workers, capitalists, and enterprisers.

Concentration upon those activities which yield higher values also contributes to the high productivity of a country in

terms of values. One implication of this rule is that if one day of work in mining, let us say, produces $5.00 of value and one day in manufacturing produces $6.00, then value productivity is increased by more people going into manufacturing and fewer into mining. The countries of highest value productivity are those in which a relatively large proportion of the workers are engaged in what has been called "secondary" or "tertiary" types of industry, especially the latter, rather than in the "primary" types. (The term "primary" refers to extractive industries, such as agriculture and mining; "secondary" refers to manufacturing and processing of materials; and "tertiary" to transportation, commerce, and finance.) This conclusion seems to be justified by an observation of the countries of the world in the recent past. There would seem to be no fundamental reason, however, why it should always be true. It is conceivable that the supply of manufactured goods and the supply of commercial services in the world might become so large, relative to raw materials, that the relationship might be reversed. Considering this possibility, therefore, it seems that the only generalization that we are justified in making is that a country should concentrate on its most effective lines, taking into account the values produced in those lines. To bring about this most profitable concentration requires mobility of capital and labor as well as initiative by enterprisers and freedom to trade goods of one country for those of another.

We have emphasized the importance of the role of enterprisers in an expanding economy. Upon them rests the responsibility for employing the other factors of production. Moreover, the enterprisers are the innovators—the ones who adopt new ways of doing things and who undertake the production and sale of new things and services. Their part in determining the amount of economic activity thus seems clear.

But the initiative of enterprisers is also an important determinant of the effectiveness of production. There is no simple, objective test of effectiveness, for it involves the question of the importance of the goods produced compared to that of the goods which might have been produced with the same productive power. In a value sense it can only be judged finally by the consumers, and then only as they are forced to make decisions on

the use of their individually controlled purchasing power, which is never unlimited. Their verdict, or rather a multiplicity of verdicts, are registered in the market place in the fact that some goods will yield more than their costs and others less. But these final verdicts are rendered after the goods have been produced and the costs incurred. It is the job of the enterpriser to anticipate these judgments. If he does so successfully, he will be financially successful and will retain his place as one of the directors of our productive efforts; if he is inept, he will lose money and will be eliminated from this important job. The first way, therefore, in which the business enterpriser contributes to effectiveness is in directing activities toward the production of most desired things. This is a problem of interpreting and of anticipating consumer demands.

The second way is in the skillful direction of men and resources to produce the desired goods. This is partly a matter of management, in the narrow sense suggested by time and motion studies, plant layout, and efficient flow of materials in the production process. But it also involves the questions of how much capital shall be employed, relative to labor, and what forms the capital goods shall take. Then there are the decisions as to place of production, methods of marketing, and many others. These latter decisions constitute the strategy of production, as compared to tactics, to borrow a military distinction. The final effectiveness of the whole process, and hence of real productivity, depends upon the judgment, initiative and sometimes the courage of those who determine these large questions of the use of productive factors.

## OUR PAST RECORD OF PRODUCTIVITY

The output per person in the United States (all persons, not merely workers) can be estimated in index numbers as follows:[10]

Output per Person (1940 = 100)

| | |
|---|---|
| 1880 | 42 |
| 1900 | 70 |
| 1920 | 78 |
| 1940 | 100 |

[10] Computed from national income at 1940 prices, Dewhurst, *op.cit.*, p. 23, and population data, *Statistical Abstract of the United States, 1944–45*.

The rate of increase also has been computed by others, and a concensus of these studies indicates a rate of increase, for the sixty years prior to World War II, of approximately 2 per cent a year, although the rate has actually been much higher in some years and lower in others. Such a rate of advance made in a large and growing country and sustained over such a period is indeed remarkable—probably not to be equaled in the history of the world. A contemplation of this record has led at least one writer to observe that, if the country could go on at this rate for another forty or fifty years, we could abolish anything which we now know as poverty.[11] This is the first time and the only place in the history of the world when sober-minded men, could, on the basis of a tangible record, challenge, within their lifetimes, the old rule that "the poor you have with you always."

This increase in production has been, as was indicated, a result of various conflicting forces: some working for decreased per capita output and others (fortunately more powerful) working for increased output. Because of this complex of forces, we cannot afford to be complacent as to the future. The task is to see what the positive forces have been and to encourage and preserve them.

It is also necessary to recognize the negative forces and to determine whether they should be opposed or to what extent they can be accepted—that is, to what extent we can afford them. The fact is that a number of these negative trends are negative only as to their effects on our supply of goods and services and represent desired ends in themselves. These evidences and prospects of productivity have referred to the production per person in the United States and thus reflect the combined effects of the proportion of the population who are in the working force, the time devoted by them to work, and the productivity per worker hour. If we turn our attention particularly to the last element, man-hour productivity, we see that there has been a continuous improvement; indeed, this improvement most largely accounts for the improved output per person of the population.

It does not seem feasible to give a single index of man-hour productivity for all lines of activity within the country. In

[11] Schumpeter, *op. cit.*, p. 66.

manufacturing, a well-known index prepared by Professor Douglas shows an advance in relative physical output per man-hour from 100 (taken as a base) in 1899 to 177 in 1925.[12] Another study shows the trend from 1909 to 1939 (see Table 4). Both these series indicate a steady improvement in this important element of national productivity down to the beginning of our war period.

It is impossible to give a quantitative measure of the changes in man-hour productivity during wartime for the reason that we were then producing quite different things from what

TABLE 4*

INDEXES OF LABOR PRODUCTIVITY (OUTPUT PER MAN-HOUR)
(Average, 1923–25 = 100)

| Year | Manufacturing | Bituminous Coal Mining | Anthracite Coal Mining | Steam Railroads |
|---|---|---|---|---|
| 1909 | 62.3 | 69.5 | 84.8 | 75.4 |
| 1919 | 71.9 | 85.1 | 100.0 | 85.4 |
| 1923 | 94.1 | 99.2 | 103.5 | 96.4 |
| 1929 | 123.1 | 107.2 | 99.8 | 113.9 |
| 1932 | 129.6 | 115.0 | 119.0 | 111.9 |
| 1939 | 164.2 | 141.0 | 178.6 | 149.2 |

* "Wages and Productivity of Industrial Labor," *Monthly Labor Review*, September, 1940.

we produce during peacetime. To take an extreme case, it is impossible to measure man-hour productivity of the armed forces; and, likewise, it is impossible to compare man-hour productivity in the production of tanks and tractors, even though their physical characteristics may be somewhat similar. But there were some products, such as airplanes, which were produced both in peacetime and in wartime; and in those cases, the output per man-hour increased very greatly. There were also marked improvements which took place in the production of munitions and war supplies. At the beginning of the war, it required 1,150,000 man-hours to build a Liberty ship, and by 1944 this figure was reduced to 515,000 man-hours. In this limited sense, then, we can say that man-hour productivity was

[12] Paul H. Douglas, *Real Wages in the United States, 1890–1926* (New York: Houghton Mifflin, 1930), p. 547.

high as to the production of war supplies. There were a number of major reasons for this fact.

For one thing, we were fortunate that the production of most war supplies called for concentration of effort on the job which we know best how to do—namely, the manufacture of large quantities of standardized goods. This huge production of standardized goods made possible a high degree of mechanization. One single example will illustrate the possibilities which this fact uncovered. A certain firm which manufactures parts for the automobile industry received an order initially for 30 million units of a certain part of a fuse, and the total ultimately produced ran over 110 million units. With this volume in sight, the company felt justified and did invest between $200 and $300 thousand in tooling—and this on a product for which the original price was 6 cents, later reduced to about 4 cents. One way of expressing this relationship is to say that the investment in tooling was some 5 million times the value of the single unit ($250,000 ÷ 5 cents). That "depth of tooling," to use a phrase employed by this manufacturer, was much greater than would be justified on the quantities of goods with which this company dealt in peacetime. The difference in the volume of standardized production of a single item, in other words, justified a much higher machine investment, which in turn increased the man-hour output and reduced the unit cost substantially. We rightly think of the automobile industry as representing a huge volume of production, but it should be remembered that the total industry, even in a good prewar year, hardly exceeded 4 million cars; the parts used in the cars are not completely standardized, and the business of producing those parts would not go to one firm. But in the illustration given, we had 110 million identical parts to be produced by one concern. Under these circumstances, the man-hour productivity would, of course, be very high. All this, however, does not have direct significance for the possibilities of producing a variety of goods for a peacetime market, although it does suggest the importance of a large market and large volume in making possible highly effective production.

The war period is more significant for our present purpose in the record of production of nonwar products—nonwar only in

the limited sense that they were not substantially different from peacetime products. They included such things as shoes, blankets, and cigarettes. With these products the picture is confused. A survey of twenty-three of such nonwar industries for the period 1939–45 showed an increase in man-hour output in physical units in thirteen instances, a decrease in eight industries, and no discernible trend in two. What the trend was for manufacturing of peacetime goods during that period cannot, therefore, be clearly established.

There are certain factors which have accompanied the recent high level of activity and which have presumably had a bearing upon man-hour productivity. They can be classified into those factors that would presumably be favorable to increased productivity and those factors that would appear to be unfavorable to it. Since there are several of each and since these factors combine in different ways in different industries, it is not surprising that the net result in different industries should differ widely. Because many of these factors will presumably continue to have significance, we shall enumerate them as follows:

1. Increased volume of business in many of the lines during the war made it possible to keep all workers employed. It should be noted that this large volume is significant, since it applies to the volume of business in individual plants and implies a high volume relative to the number of workers employed in that plant. When there is enough work passing through a plant to keep all the working staff busy, the output per man-hour should be greater, other things being equal, than when the minimum required force is employed only part of the time.

2. A high demand for labor made it difficult to maintain "stand-by" workers.

3. There was less moral compulsion on employers to keep unneeded workers on the job. During the depression years, many an employer hesitated to lay off workers, particularly those of long employment, because there was no other place for them to go. Since 1939, this consideration has been weak or absent; and particularly during the war period, it was regarded as unpatriotic to keep more workers on a job than were really needed.

4. Because of the scarcity of labor and high wages which

reflected that scarcity, there was pressure upon management to "save labor," that is, to use it most effectively by better supervision, more serious attention to time studies, and other devices. This was simply an application of the principle that we normally strive to use most economically those factors and services that are scarce.

5. The same considerations led to the use of the most effective machinery which could be obtained.

6. It was apparent to the worker that there was no serious danger of working himself out of a job. This does not mean that there were not slowdowns; but the immediate economic force leading to them, which had been so prevalent during the thirties, was removed. Such slowdowns as occurred had to be explained and initiated on other grounds.

7. The obvious need for more production and the removal of fear of exhausting the supply of work led workers in some industries to accept more readily incentives plans which had the positive effect of stimulating worker activity.

8. During the war period, there was the patriotic motive to contribute to the war effort, which had a favorable effect on the morale of workers and managers. Unfortunately, the objective of a high level of output does not apparently make the same appeal during peacetime.

Among the factors, on the other hand, which presumably contributed toward reduced man-hour output the following may be mentioned:

1. Under a high level of employment, and especially such an extreme demand for labor as existed during the war, it was necessary to employ marginal workers or, more strictly speaking, workers who in other conditions would be extramarginal workers. These included many people who were inexperienced in industrial work, many old people, and those who were not in their physical prime. To describe these workers in this way is not to question their value. It was indeed such workers who supplied that margin of manpower which was so sorely needed in the war effort. The comment simply means that, when only part of the workers of the country can be employed, the ones chosen will likely be the more effective ones. The others in a

sense constitute a reserve which becomes very important in an emergency. But their employment tends to reduce the average output per worker. Moreover, the increased employment required up-grading all along the line. Erstwhile floor sweepers became operators, and operators became foremen, and so on.

2. At a time when labor was extremely scarce, there was a tendency for each enterprise producing war supplies to hoard labor. This was to be explained partly by the profit motive. It was often worth while to keep employees on the payroll against the not too distant time when it was known they would be needed, even though such a practice tended to reduce man-hour productivity and was, no doubt, bad practice from the point of view of the whole nation. But it was not altogether a matter of a selfish desire for profits, for each company naturally tended to regard their obligation to turn out the particular products assigned to them more highly than they did the needs of other companies. It was a healthy state of mind that individual enterprises should be duly impressed with (and even that they should exaggerate) the dependence of the whole war effort upon their own project. The consequence of the resulting tendency to hoard labor, however, would be to reduce the man-hour productivity for the whole country.

3. Longer workdays and work weeks were necessary; and, while these devices added to total output, they no doubt tended to reduce the man-hour output. Some managers doubt if they always increased total output.

4. Similar considerations required, or were thought to require, protracted work without vacations. The high wages which many workers felt were temporary contributed to their voluntary foregoing of vacations, as did the patriotic consideration. This protracted work again may have increased total output, but it no doubt tended to reduce man-hour output.

5. The morale of workers was, in many cases, adversely affected by the knowledge that they were in a "worker's market" and that they did not need to fear the consequences of losing their jobs, for other jobs were readily available. Likewise, the employer hesitated to insist upon high working standards

for fear of losing his workers. For these reasons, there undoubtedly was a deterioration of shop discipline.

6. There were also notorious cases of deliberate slowdowns, immediately resulting in part from the increased power of unions and in part from the previously mentioned decline in shop discipline. On the positive side, we mentioned that the economic pressure for slowdowns arising from fear of working one's self out of a job had been reduced. The factor mentioned here was not so much economic in its nature as it was the very human desire to "take it easy" and the opportunity for doing so with impunity. Perhaps, as has been suggested, the quite human revolt against authority was combined with the opportunity to "get away with it."

7. Because of the shorter experience and lower quality of some of the workers during wartime, there was increased need for more supervision. This need was also enhanced by the fact that, in the shift to war production, many new types of jobs were created and workers had to be trained for them. The result was a great need for people to train workers and to supervise their activities. But at the same time, there was a shortage of supervisors, as there was of all other classes of employees; and this shortage was aggravated by the drafting of such men into the military services. Consequently, while the task of supervision was increased, the available supply of effective supervisors, particularly at the lower levels, was decreased. As a result, the quality of supervision, particularly at this lower level, was not always as high as could have been desired.

8. During the war period and continuing into the postwar reconversion, an imbalance developed between production and demand which tended to create bottlenecks. This situation required priorities and allocations of materials, parts, and equipment. Modern production is a highly integrated thing; and even though the producers of practically all parts of a finished product are producing in reasonably adequate amounts, if there is even one essential part which is not being so produced, that one can hold up the whole production. This is the phenomenon of a bottleneck which is likely to develop at any time when a sudden

shift in the direction of the efforts of the economy is made. Such a shift on the largest scale ever known to us did take place when we converted for war production and again when we reconverted for peacetime production.

9. Quite aside from this unbalanced production, the very conversion of peacetime industries, for example, automobile production, to the manufacture of munitions of war reduced the rate of productivity. This major shift was aggravated by the numerous changes in the requirements of the armed forces. Many of these were unavoidable, being caused by changes in our tactics and changes in enemy equipment and by inventions and improved designs made by ourselves during the war. Corresponding changes, of course, take place during peacetime; but by the mechanism of the price system, they are made more gradually. For example, when an improved type of household equipment comes upon the market, we do not ordinarily cease production of the old types while we retool for the new one. Rather, it usually takes some time to introduce and promote the new product; and this fact, as well as the natural desire of enterprises to avoid a complete scrapping of old equipment, tends to soften the impact of change. Such considerations do not weigh very heavily during wartime; in the first place, the change in demand is made by one unified authority instead of by millions of consumers, and in the second place, the economic considerations are almost completely overridden by military requirements.

It is apparent, then, that the resultant man-hour productivity in the war and immediate postwar period was a composite of many conflicting forces. A number of lessons can no doubt be drawn for peacetime from these experiences. One conspicuous one seems to be that overemployment brings its problems just as does underemployment. (By "overemployment," we mean a situation in which there is a demand for more workers than are available.)[13] In some respects, such a high employment situation

[13] Sir William Beveridge argues in his *Full Employment in a Free Society* (London: G. Allen and Unwin, Ltd., 1945), pp. 17–18, that an ideal situation would be one in which there were more jobs available than men to fill them. Surely one's ardor for this ideal needs to be tempered by the serious possibility that worker motivation, effort, and shop discipline might seriously deteriorate under such conditions. A manufacturer who had extensive experience in production under war conditions commented rather bitterly that it was apparent that Sir William had never tried to run a factory under those conditions.

contributes to an increase in man-hour productivity; but in other respects, particularly as to the quality of workers and their motivation, the opposite effect is induced. If we are to maintain a high level of employment in this country, which of course everyone desires, and if we are to maintain this essential ratio of man-hour productivity, we must develop a more healthy attitude of all concerned toward the maintenance of high production. We must, in short, develop a self-discipline and perhaps more positive incentives which will become effective as the negative incentives (necessity, fear of losing a job, and others) decline.

## INTERNATIONAL COMPARISONS

While it is generally recognized that the United States is, by a wide margin, the leading industrial country of the world, it is difficult to give precisely comparable figures to express that fact. This difficulty arises in part, in so far as values are concerned, from the different currencies and, particularly in late years, because of the absence of a common monetary standard which would enable us to express values in comparable terms. Nevertheless, certain bits of data can be combined to throw some light on the relative position of the United States and other countries.

The national income of the United States even in 1928 was about $84 billion, while in the second country in order, the United Kingdom, it was about $19 billion; in Germany $18 billion; and in France $8 billion. Our national income shrank radically during 1930–40, more so than that of most other countries of the world; but even so, our national income in 1936 was about $66 billion; Germany's was estimated at $26 billion; and the United Kingdom's at $22 billion. If we make allowance for the differences in population and express national income in per capita terms, the United States in our prosperous year of 1928 stood at $794, compared to $411 in the United Kingdom and $279 in Germany. By 1936 our per capita national income was $511, that of the United Kingdom $457, and that of Germany $388.[14]

[14] 1928 figure from *Encyclopedia of the Social Sciences*, Vol. XI, p. 206; for 1936, *Economic Almanac, for 1944–45* (New York, The Conference Board), p. 322.

It will be noted that during the time of our great depression, Britain and Germany had made substantial recovery from theirs; but even so, the national income of the United States was still substantially above that of these other countries. Here, incidentally, is a fact which is often given less than its due weight. It is often said that the American economic system does compare favorably with that of other countries in our good years but that this depends upon the maintenance of a high level of activity in this country and would disappear in time of depression. While it is true that the social and political strains engendered by dropping from a high to a lower economic level would be serious, past experience does not justify the conclusion

TABLE 5*

OUTPUT OF COAL PER MAN-SHIFT IN THE YEAR 1935
(Index Numbers: Belgium = 100)

| | |
|---|---|
| France | 112 |
| Great Britain | 153 |
| Czechoslovakia | 172 |
| Germany | 220 |
| Netherlands | 232 |
| Poland | 261 |
| United States | 525 |

* *Monthly Labor Review*, June, 1938, p. 1,386.

that under such unfavorable conditions in this country and the most favorable conditions abroad, the American system should suffer by comparison.

As has been emphasized in previous pages, this superiority in income rests primarily upon our man-hour productivity; it is not true that a larger proportion of the people of the United States are normally employed or that they work more hours. It is not possible to give general indices which would compare man-hour productivity in this country and abroad. Estimates are available for particular industries. These are significant, although it must be recognized that the lines represented are in the manufacturing and mining groups in which our advantage is presumably greater than in others, notably personal services and commerce. Bearing this in mind as a qualification, it may nevertheless be enlightening to observe some of the data regarding particular industries. Table 5 shows the physical output in the coal industry in several countries of the world.

It is also possible to make some detailed comparisons between the United States and the United Kingdom which have special significance, because in the industries mentioned the latter country is the most comparable to our own. The figures in Table 6 express the output per worker in various industries in the United States in comparison to output in Great Britain.

These figures are the more striking if account is taken of the shorter hours in the United States, since hours worked averaged 38.6 here and 47.2 in Britain.[15] The figures, then, must be explained by greater effectiveness in the United States. As we have previously indicated, such superiority in effectiveness arises from a number of factors, a very important one being the use of capital and mechanical power.

TABLE 6

PHYSICAL OUTPUT PER WORKER IN VARIOUS INDUSTRIES IN UNITED STATES
(British Output per Worker = 100)

| | |
|---|---|
| Radio sets | 482 |
| Motor cars | 419 |
| Iron and steel products | 400 |
| Machinery | 280 |
| Soap | 279 |
| Rubber tires | 266 |
| Coal | 261 |
| Rayon and silk | 160 |
| Cotton spinning | 120 |
| Cement | 106 |

Certain cautions, aside from the statistical problem of measurement, should be observed in considering data of this kind. One of these, from the point of view of businessmen competing in world markets, is the essential fact that unit costs are in terms of dollars. Thus, while it is true that our workers produce more per man-hour, it is also true that their hourly wages are substantially higher. The mere fact that we can produce a product with less labor than another country would not mean that we can undersell that country if our wages are above the other by more

[15] Mordecai Ezekiel and Associates, *Towards World Prosperity* (New York: Harper & Bros., 1946), chapter by E. M. H. Lloyd, p. 52. Data are derived from an article by L. Rostas, *Economic Journal*, April, 1943, pp. 39–54; and finally from the *Census of Production* for each country in the years 1935–37.

than our productivity for, of course, goods are sold in monetary terms, and dollar cost depends upon the wage of labor as well as the productivity of that labor. This fact suggests that if a country is to compete successfully, its money wages and the prices of other factors must be kept in line with relative productivity. Since the wage level of a country is determined, not by the productivity of any one industry, but by productivity in general, it will always be true that, even though a country were superior in terms of physical productivity to all others in the production of all things, there will be some industries in which the money costs will be higher than in others. Thus, a general superiority of production in physical terms gives no basis for a policy of trying to produce and export all products.

Despite this and other qualifications, however, it is true that the economic well-being of a country rests primarily upon its physical productivity per man-hour; and the prosperity of the United States will depend more upon that basic fact than upon any other.

## RELATIVE IMPORTANCE OF EFFECTIVENESS AND AMOUNT OF WORK

We see that the detailed factors determining the amount of production and consequently, the economic well-being of a country are many and complicated, although they can be grouped under the two main questions of the effectiveness of our work and the amount of our work. While both of these factors are important, it is nevertheless possible to observe that the former is the more important. This will be denied by many people. Particularly during the thirties we seemed to accept the view that the most important problem (indeed, as some economists would have it, virtually the only problem) was full employment, which of course is one aspect of the amount of work. That was no doubt our most important immediate problem, but a view that is broad enough to encompass all countries of the world and which is long enough to give historical perspective reveals a different answer to the large question of the determinants of economic well-being.

If we consider the standard of living of the different nations

of the world—for example, the level of economic well-being in the United States and in China or Roumania or in France or England—it becomes clear that the higher level of this country is not due to the fact that we work more. Indeed, the amount of work done probably varies in inverse proportion to the economic well-being of these countries.[16] In a country of lower economic standards, hours of labor are commonly longer, more members of a family work, and individuals start work earlier in life and continue work longer in their old age. Moreover, in the history of our own country and in the history of Western countries generally, in the last century and more, there has been a progressive reduction in the sheer amount of work; and this has been accompanied by an improvement in the standard of living. Evidently, the difference between the United States and a country like Poland lies not in the amount of work performed but in the effectiveness of that work, using that term in the broad sense which we have given it. It is equally clear that our higher standard of living today, compared to that of Civil War times, is not explained by harder or more work.

This, of course, does not mean that the people of those other countries today or of this country in the past would have improved their real incomes by working less. Rather, it means that, as the productivity of a country increases because of its improved effectiveness, that country can afford the luxury of a protracted period of education, early retirement, a reduced proportion of its population kept at work, and reduced hours of labor for those who do more work at any given time or place to produce more goods. Our higher standard of living does, nevertheless, indicate that full employment (in the broad sense of the maximum number of people working a maximum amount of time), or a practical approach to it, is a factor which is second-

[16] It does not seem feasible, with data at hand, to state these differences between countries precisely. The labor force does not express it when we are comparing countries of widely different standards. The reason is that, as a country becomes more advanced, and we know from general observation that fewer of its people have to work, more people are nevertheless employed in the definite and countable way and are included in the measurable labor force. This is illustrated by the fact that in our own history the proportion of the population counted in the labor force increased sharply from 1860 to 1900. This surely does not mean that more of our people were working in the latter year, but merely that more of them had been caught up into our market economy.

ary in importance to the effectiveness of employment. Apparently in the past and presumably in the future, continued improvement in economic well-being will flow primarily from the effectiveness of our work—that is, from the supply of capital and enterprise and the other factors that have been reviewed.

Even the cyclical nature of our production with its unfortunate depressions and enforced idleness can be tolerated, at least from an economic point of view, if the general level of productivity is kept high. If this seems too strong a statement, let us recall that the per capita production in the United States, even in our worst years of depression, was high relative to the best years of many other countries and to the best years of our not-too-distant past. If the level of production is high enough, it is possible to make provision for those who are unemployed in depression years. It is more important that we maintain such a level of production through good times and bad, so that we shall be able to take care of the hardship cases in the worst years, than it would be to stabilize production if that stability were to be at a low level. In other words, if our production can normally be kept well above a necessary minimum, we will be able to withstand temporary declines without passing below that minimum. To support a satisfactory system of social security requires, in this country, several billions of dollars a year. When, in the late thirties, Sir William Beveridge's social security plan for Great Britain was advanced, there was considerable speculation as to how much a comprehensive plan of that type for the United States would cost. Taking into account our larger population and our somewhat higher acceptable minima, the estimates were between \$8 and \$11 billion a year even at prewar prices. Only a country of high per capita productivity could support such a program. Indeed, the United States is the only country whose past record and immediate prospects give any basis for serious discussion of a social security program that would spell reasonable minimum security according to standards prevalent in this country. The maintenance of a high level of productive employment is one of the major problems posed in this book. The qualifications made here are merely intended to

place that problem in the proper perspective and to suggest that if we desire high living standards we cannot afford to yield very much in sheer man-hour productivity in our search for stability, security, and other desired ends. No nation ever became great by seeking security. Indeed, in view of continually advancing concepts of satisfactory minimum standards, it is doubtful if a country can even gain security by making security its chief goal. It may well be that security, like happiness, is not to be attained by the direct approach but comes as an indirect fruit of other objectives, of which high productivity stands high in the list.

## QUALIFYING CONSIDERATIONS AS TO THE FUTURE OF AMERICAN PRODUCTIVITY

The reasoning and evidence presented so far seem to hold a promise of continued progress in the improvement of living conditions of the American people and to provide a prospect of such relative advances, as compared to other countries, to insure the economic leadership and security of the United States, vis à vis the other countries of the world. There are, however, a number of other forces that should preclude any excess of easy optimism. Even on the important factor of man-hour productivity, with which we have been so much concerned in this chapter, we must guard against a common tendency to think of it only in terms of manufacturing and other mechanical industries. The well-being of the country depends fully as much upon productivity in other industries. This observation is particularly important because a shift is going on in the proportions of employment away from manufacturing, mining, and agriculture to distribution and personal services; and it happens that our relative productivity is higher in the first categories than in the latter ones.

In manufacturing, man-hour output has shown a long and marked improvement. From 1900, for example, to 1925, it increased in the ratio from 100 to 177.[17] The increase since 1925 has also been striking. In agriculture, data are not available over such a long period of time. But a recent study of the De-

[17] Douglas, *op. cit.*, p. 547.

partment of Commerce reveals a truly phenomenal increase in productivity from the mid-thirties to the mid-forties.[18] Comparing farm production for the average of 1935–39 with 1946, it appears that the number of workers declined by about 8 per cent while the physical output was increased by 31 per cent, which means an increase of output per worker of 43 per cent. There has probably been no time in the history of the world when any nation has increased its effectiveness in the production of food products by any such amount. Indeed, this increase in output per worker for farm products in the short period of ten years is probably as great percentage-wise as the increase which took place, for example, from the time of the Roman Empire to the beginning of mechanized agriculture about one hundred years ago. Some allowance, it is true, has to be made for the fact that the increased mechanization of farming, which contributed so heavily to this advance, called for fuel produced by another industry rather than for fodder produced by the farms themselves. But even so, the advance has been truly revolutionary.

But the great success which we have enjoyed in manufacturing and in agriculture has increased the problem of marketing. Goods are produced at greater distances from the points of consumption; also the greater variety of goods places a greater burden upon distribution. These and other reasons explain why increased output in tangible goods requires a disproportionate increase in the number of people to distribute those goods. This is another way of saying that man-hour productivity in marketing has not kept pace with the improvements in the other lines; this is not surprising when we remember that the use of machinery and a high degree of division of labor are not so feasible in marketing as in manufacturing.

The relatively lower effectiveness of this country in marketing than in production, which we believe to exist, cannot be readily demonstrated. One group of figures, applying to a part of the distribution system, is submitted, not as proof, but to illustrate the problem. These refer to operating results of medium-sized department stores in different countries. In the mid-thirties the gross margins of such stores (the difference be-

[18] Reported in *United States News*, May 16, 1947.

tween what these stores paid for goods and what they received for them—in other words, the percentage of the value of the goods absorbed by the retail stores) were: in England, 31 per cent; in Germany, 32.5 per cent; in Denmark, 31 per cent; in Switzerland, 32.5 per cent; in Finland, 31 per cent; and in the United States, 36 per cent.[19] This larger gross margin could not be explained by larger profits, for these were smaller in the United States than in some of the other countries. The cost in this case is largely a function of sales per person employed in those stores and their wages. Our sales per employee were somewhat above that of other countries. (It was about $6,000 in the United States and $5,750 in Germany.) But American wages exceeded those of other countries more than our effectiveness—a fact which was not true generally of agriculture, manufacturing, and mining.

The conclusion is that we are finding it easier and easier to produce goods, but we are not finding it correspondingly easier to distribute them; and in so far, therefore, as our problem becomes one of distribution instead of production (using the term in its narrow sense), the rapid gains of the past may be slowed down. Another significance is that a major problem confronting American business is to devise more economical ways of distributing the goods which we have learned to produce so well. Incidentally, from the point of view of young men going into business, rich rewards would be expected to result from progress in this growing and crucial field.

The other growing field is that of personal services, which includes the services of entertainers, barbers, beauty-shop operators, doctors, dentists, and others in the field of public health. This field is growing most rapidly of all; and it can be expected to continue to grow, not because of the sheer necessity imposed upon this segment of the economy as was the case in marketing, but because, as people's needs for tangible goods are more nearly satisfied, they naturally turn to these services. In these fields there is no evidence of increasing effectiveness except possibly (as to some of them) in a qualitative sense. There is thus less

[19] Data from McNair, Teele, and Hirsch, *Distribution Costs, an International Digest* (Cambridge: Harvard University Press, 1941), p. 617.

ground for complacency as to the future than if we were to concentrate attention merely upon the production of material goods.

Moreover, while the American record of man-hour productivity as a whole has been good (one could say brilliant) and there are grounds for hoping that it will continue to improve, nevertheless, it should be recognized that part of the good record of recent years has been due to factors that may not repeat themselves or be continued. During the war period in particular—indeed, since 1939—an important factor has been the increased volume of work to be done. It was pointed out in a previous section that there are several ways by which this increased volume could be expected to reduce the man-hour output. Under such conditions of full employment, and even of excessive employment, the necessity arises of employing workers of poor quality; and it would be expected that their presence in the working force would reduce the average of output. But on the other hand, a high volume of business which makes it possible for a plant to work at capacity, in the sense of keeping machines employed, also makes it possible for workers to be kept continuously employed during the working day. The high volume also makes possible more efficient division of labor and routing of materials through the plant, and these forces contribute sufficiently to increase man-hour productivity to offset the detrimental factors.

The effect of large volume has been particularly noticeable in retailing and other merchandising establishments. An index commonly watched in retail establishments, for example, is the sales per sales person. This index for most stores reached an unprecedentedly high level during the war years. This was because retail sales volume was high enough to keep the regular staff fully employed and even "over-employed." It was impossible, because of the labor shortage, to secure additional employees even when stores would have been glad to engage them. The result was that promptness and quality of service to customers was impaired; but it was still true that a larger amount of trade was done with a smaller number of salespeople, and in this sense man-hour productivity was greatly increased.

This high level of activity is only effective in contributing

to higher rates of man-hour productivity when the country is moving from low production and employment to a higher level. Once it has attained full employment, as it had by 1945 or 1946, no further gains are to be expected from that source.

The increased output in a number of lines, however, resulted in part from better equipment, better organization of the working staff, and more intensive effort on the part of management to conserve labor. There is no reason why these factors should diminish, for they depend upon an increasing supply of capital, the increasing ingenuity of inventors and manufacturers, and a continuous supply of imagination and daring on the part of enterprisers. There is no limited supply of these qualities. If the environment for the encouragement of them is maintained, we may reasonably look forward to their continuance in the future.

From these trends toward a different pattern of consumption and production a number of conclusions could be drawn. It appears that the devotion of a considerable part of our time to the better distribution of goods means improved convenience to consumers and enhanced availability of goods, and these can be taken as features of improved economic well-being. Likewise, the enjoyment of more personal services is also evidence that we have made sufficient progress toward meeting our material needs so that we can afford to devote time to those services which may contribute as much or more to good living as the goods themselves. All this is to the good; but at the same time, we should recognize that in these two lines we do not have a marked superiority over other countries of the world; and if this country and others continue to follow these trends, the comparative superiority of our economy may not be so clear.

In so far as we are engaged in the production of automobiles or any other manufactured products, it is quite clear that this country is pre-eminent but there is no clear evidence of pre-eminence, and certainly not in the same degree, in personal services and marketing. In so far as our customary standard of living comes to depend more upon these latter services and less upon the production of goods, our relative superiority would be expected to decline. The challenge to this country, if it is to make a

favorable showing relative to other countries, will be not only to maintain its superiority in mechanical trades but also to improve its effectiveness in the other phases of economic activity.

An economist of the present day must feel almost apologetic for laying emphasis on the relative positions of the nations. The great thinkers of the eighteenth and nineteenth centuries—David Hume, Adam Smith, John Stuart Mill, and others—were able to take the world as their subject of concern; and even when they were considering the well-being of their own country, they could recognize that its prosperity depended upon the prosperity of others. It was a cosmopolitan and essentially a humanitarian view. But in a world of warring ideologies and one in which force has been exalted, it is no more than realistic to recognize, in the words of Wendell Willkie, that in the world of today "only the productive can be strong and only the strong can be free." If that is true, the American people must look to their productivity, not only as the basis for good living and abolition of the curse of poverty, but also for the safety of the republic.

## PERMANENCE OF THE BASES OF ECONOMIC PROGRESS

The radical improvement in the general economic condition of the people of the United States and Western countries generally started with the Industrial Revolution, the beginning of which can arbitrarily be set in the latter part of the eighteenth century. In a real sense, the Industrial Revolution was not something completed in the historical past. It has continued to the present time and is still with us. The progress in economic well-being in the future, as in the past, depends upon the development and expansion of the fundamental forces which characterized it. It behooves us, therefore, to remember what those basic forces were. They can be described in many ways; but at the risk of oversimplification, let us say that they were chiefly four: the use of machinery, specialization, wide markets, and free enterprise.

One of the most obvious features of the Industrial Revolution, both in its early stages and in its later development, has been the increased use of machinery. Evidences of this and some

of the consequences have been indicated in previous paragraphs. This use of machinery involved the remarkably fruitful combination of efforts of four groups of people: scientists, inventors, capitalists, and enterprisers. The relationship between scientists dealing with the basic laws of the physical universe and practical inventors, such as Arkwright and Watts in England and Franklin and Edison in the United States, was one of mutual aid and mutual dependence. The eighteenth and nineteenth centuries were marked by one of those great outbursts of human intellect which come at such long intervals in the history of the world. But the inventions and the basic sciences which contributed to them would have had little bearing upon the economic conditions of people if the inventions had not been utilized by imaginative enterprisers. It is reported, for example, that the principle of the steam engine was discovered in ancient Alexandria; but the engine was only used as a plaything, and the knowledge of it passed away as a matter of no practical significance. Fortunately, England, and afterward the United States, had a goodly supply of imaginative and practical men who, moved by the desire for gain, seized upon the inventions as rapidly as they were made and stimulated inventors to further efforts. Moreover, the utilization of these inventions required capital (which, in its broadest sense, is the accumulation of wealth that can be utilized to enable people to devote their time to the production of goods which will yield their fruits in the future); and this accumulated wealth was available.

The second major factor is specialization and its counterpart, division of labor. Considerable progress in dividing jobs, so that individuals specialized on only parts of them, was necessary before machine production could take place. Generally speaking, it is impossible to devise a machine which will produce a whole finished product. The machine can be used to perform a specialized function and must be combined with other machines which are performing their specialized function. Adam Smith, the great interpreter and prophet of the Industrial Revolution, clearly recognized this relationship and placed great emphasis upon the advantages and conditions necessary for specialization. This specialization takes place at the level of

individuals breaking down a general job into its component parts; but it also involves division of labor as between different areas so that certain communities or even regions of the world devote their attention to the activities in which they have natural advantages. This method of production, of course, was in contrast to the characteristic production of the feudal age in which most of the things desired for the manorial group were produced at the place of use and in which only the simplest forms of specialization between individuals took place.

Widening markets were necessary in order to make possible the specialization and the use of machinery. The reason for this is that no one community can specialize in the production of one thing unless it can trade that thing with other communities which are specializing in other things. Likewise, the investment in machinery can only be justified if there is a large sale for the product, and this requires relatively wide markets. The Industrial Revolution was made possible by the fact that the areas of trade had been widened within England. Better roads and means of communication, orderly and peaceful conditions, and a common system of commercial law had been established throughout the kingdom; and during the eighteenth century in particular, the same conditions were extended to other parts of the world, especially through the building of the British colonial empire. Thus, the markets were ready to absorb the quantity of goods which would be the product of the machines.

Free enterprise, which is meant here as individual initiative, was a necessary (or at least very helpful) factor in making possible the radical changes in productive methods and industrial organization which characterized the Industrial Revolution. The reason is that a considerable amount of experimentation and the intensive efforts by many people who were willing to stake their own capital and efforts on the hope of gain were needed to crack the cake of custom. One cannot say with assurance that the radical changes of the Industrial Revolution could not have been brought about by concerted and organized action. But it does seem clear that changes were fostered by that freedom of experimentation which permits individuals or very small groups to try out methods which the mass of the community is con-

vinced would not work. That, indeed, was the history of the steam engine, the railroads, and nearly all of the early improvements.

The reason for calling attention to these factors is that, if we expect continued improvement, we must continue to rely upon those same basic factors because they are not to be changed by ideologies or changing fashions in political or social thought. They are instead the elementary and fundamental requirements of industrial growth. The conclusions for us and for other countries are obvious: whatever the social forms, continued progress requires an adequate supply of capital; it requires the invention and utilization of machinery; it requires a high degree of specialization, which in its broadest sense demands considerable freedom of trade over national and worldwide areas; and it calls for someone to take the initiative for the adoption of new methods. All this is comprised in what has been well called the "logic of the machine."

The essence of all of these is freedom. It will be recalled that the nineteenth century, in which the Industrial Revolution surged forward, was marked on the side of economic policy, by the extension of free trade; on the side of political institutions, by the growth of representative government; and in political philosophy, by a preoccupation of thinkers and statesmen with the rights of individuals. This congruence of forces in these three fields was not a coincidence. They were three aspects of freedom. As they supported the Industrial Revolution in its early stages, so they must support its continuance.

This view of our future prospects is conservative in that it holds the fundamental requirements of industrial growth to be the same today as they were two hundred years ago, and almost certainly these requirements will continue to be the basic ones in the future. It is clear, however, that the most favorable conditions for the development of these forces have never been completely attained and that such progress as would capitalize upon our potentialities may require some radical changes from our actual practice, if not from our basic theories. The abandonment of the restraining forces of monopoly in all its forms and the development of a free flow of capital and goods would be

radical moves, if thoroughly applied in this twentieth century. Our point of view, then, is conservative as to basic ends; it is radical as to the means of effectuating them.

## THE PRAGMATIC APPROACH

We have discussed such tangible and down-to-earth factors as the amount of work done and the number of units of production that can be turned out with a given amount of that work, instead of laying emphasis upon the popular subject of present-day discussion, namely, forms of social organization and schemes of distribution of the social income. This emphasis has been deliberate. It is my belief that the success of the race as a whole and of the different countries within it in attaining the material basis of the good life depends primarily upon success in production. It has become very popular to say that we have solved our problems of production, that the misery of the world is to be described as "want in the midst of plenty." These statements simply do not describe the facts. The world as a productive organization is still far from able to supply the goods necessary to abolish poverty and want, let alone to insure the abundant life to people generally. The total production even in the United States falls short of that ideal, and the world at large is very far from attaining it. Our problem still is to produce more of the good things that the people of the world desire. It must be solved by the unromantic but tremendously important ratio of the output per man-hour.

In the rivalry of different forms of social organizations for acceptance by the peoples of the world, the ultimate choice, it is believed, will be made on the basis of this tangible fact of production. The forms of social organization will stand or fall by their works, not by the attractiveness of their ideology. The view thus expressed is a pragmatic one in the sense that the form of social organization which will prevail will be the one which works best; and the test of working best will be its output. In this respect, forms of social organization are like biological species. There is limited land and resources in the world, and there is competition among the different biological species to obtain those resources. Among the species it is clear that those

which can make most effective use of the resources will control them. Likewise, it is our view that those forms of social organization which can use resources most effectively to the satisfying of human wants will in the long run control the world. This does not imply an extension of legal sovereignty or military conflict necessarily, but perhaps merely the peaceful shift of power to a people or to a form of social organization. When England and some other parts of Europe abandoned feudalism and entered the Industrial Revolution, they were bound to gain supremacy and power relative to countries like Spain which had held them under the old regime. The institutions of freedom were making headway the world over. The victory was determined, not by arguments over the merits of freedom, or control, or by other ideological considerations, but by the sheer productive power of the system of freedom.

To this view it may be objected that production has its qualitative as well as its quantitative aspect, and that if a nation or the members of a civilization concentrate their efforts on the refinements of living rather than on the production of things that could readily be converted to defense, they might, in spite of their productivity, place themselves in a vulnerable position. (It is true that Carthage, which perhaps was the more "productive" city, did fall before the iron fist of Rome.) Perhaps this must be accepted as a qualification, especially as to the significance of productivity in a short war. But over the long period which commonly characterizes the rise and fall of civilizations or even of nations, productive powers can be converted to meet changing conditions, and it is, therefore, believed that capacity for production will finally be decisive even if, unfortunately, the rivalry of nations takes the destructive form of armed conflicts.

Moreover, much of the ideological discussion turns around the questions of justice and distribution of incomes on the basis of equity and deserts. These are questions which can never be answered and hence are comparatively futile. For example, workers of today do live substantially better than they did four or five decades ago. That improvement has not been brought about by the fact that workers are more intelligent or that they work harder—factors which might be regarded as giving them

an ethical claim to improved rewards; rather, it has been brought about by the fact that the supply of the other factors of production, notably capital and enterprise, has so increased that the output available for distribution has been increased. As these other factors have increased, the supply of labor has by comparison become scarce and more productive and can command higher returns.

Whether it is justifiable that the factor which was less responsible for the increase in productivity should derive as much or more than the others, is an abstruse question and quite irrelevant. The practical point is that, when other factors become more plentiful, the remaining one becomes relatively productive and scarce. It is, therefore, valuable and can command a high price; moreover, we need to conserve its use and to encourage an increase in its supply. Generally speaking, a high price induces those results. It is those results, rather than the arguments over abstract justice, that will be decisive.

We are concerned, therefore, that we should follow such policies as will provide the necessary incentives and conditions for the effective functioning of the society as a productive unit. We do not, for example, argue for substantial profits on the basis of justice; but if that argument is made, it must be made primarily on the basis of the effect of such rewards upon the volume of production. Likewise, other shares in distribution—wages, interest, managerial salaries, and so on—must be justified on this same ground. They must be justified by their fruits, and their most important fruit is their effect on the total volume of desired goods and services produced and made available to the whole society.

# Part II

# THE ENVIRONMENT

# 12

## *MUTUAL AND DIVERGENT INTERESTS OF ECONOMIC GROUPS*

THE maintenance of a social environment in which individuals can, to the highest practical degree, attain the ends that to them seem good is the objective which we set for ourselves in the first chapter. To visualize the kind of a social environment which will be favorable to that objective, it is important that the extent of the mutual dependence of these individuals be recognized. Also if the necessary adjustments of the claims of different groups are to be intelligently made, it is equally important to recognize the extent to which their interests diverge. Nothing is gained by an unrealistic denial of certain conflicts of interests, but there is still greater danger in an exaggeration of them.

The conflicts of group interests within a society may exist in either an objective or subjective sense. In a particular situation, for example, it may be that the advancement of the interests of two persons or two groups will proceed together and that the progress made by the one will serve as an aid to the progress of the other. This may be the objective fact. But if this fact is not recognized, or if the relationship is misunderstood, there may exist an attitude of hostility between the two groups; and this attitude constitutes the subjective basis for conflict. To say that a conflict of interest is merely subjective is not to dismiss it as unimportant; for in the field of action, people's thoughts and attitudes are highly important, whether or not those thoughts and attitudes are grounded upon objective facts. If, for example, it is believed that the interests of workers and capitalists are generally opposed, as they are pictured in the socialist doctrine of the class struggle, then that belief will influence the political and social policies of the community which

holds it. Thus, we might argue that a consideration of this subject should consist primarily of an appraisal of attitudes; but if these attitudes are based on unwarranted assumptions and interpretations of the facts, it should be possible to change them by removing the misunderstanding. For this reason, our chief interest will not be in the attitudes which people hold but in the objective facts dealing with the interrelations of the several groups, as these facts affect the people's economic well-being.

## GENERAL STATEMENT

Putting the matter broadly, we can say that the economic interest of practically all individuals within an interdependent society will be advanced by the effective and general employment of the human and natural productive resources and by the consequent high and rising level of productivity and real incomes. In recent years there has been a tendency to present every problem as one of some group *against* others: little business versus big business, workers versus managers, farmers versus city people, poor against rich. To some extent this "versus complex" was subordinated to general interests during the war, but that apparently was because we had the United States versus our foreign enemies. It is indeed easier to resolve problems into issues between our side and our opponents; it is primitive and psychologically satisfying. But it is not a very fruitful approach to the greatest economic problem of all: maintaining a high and rising level of production. That problem is one in which everyone is concerned. Wage earners, as a class, have perhaps the most obvious stake; for such a level provides them with employment, money wages, and the goods required for raising the standard of living and increasing freedom and security. To farmers and other self-employed persons, such a high level of employment provides markets; to bondholders and owners of insurance policies, the funds of which are invested in stocks and bonds, it provides security; to business proprietors, it provides solvency, current income, and economic growth; to everyone as consumers, it provides desired goods in abundance; and to government, regarded as a separate entity from the people, it pro-

vides the incomes from which taxes must be collected and on which government credit rests.

This high degree of interdependence has probably never before been equaled for such a large number of people and over such a large area as is involved in the modern industrial state—to say nothing of the interdependence between such states. This fact and its recent development, especially in the United States, imposes requirements of a breadth of view, understanding of the functioning of the economic system, and self-restraint to which it appears, at times, we have not grown up. We still act, and our political leaders often talk, as though the profit to one group was to be gained primarily at the expense of another.

But the fact is that, if we have depressed trade and a reduced volume of production, hardly anyone can escape the consequences; and if business is healthy and expanding, employment is bound to be good, real wages high, dividend payments good, and government credit improved. This fact, it would seem, has been sufficiently demonstrated to a people who have lived through the prosperous mid- and late twenties and then through the dark years of the early and mid-thirties. We have seen that long lines of unemployed go hand in hand with ruined fortunes and reputations, bank failures, and farm foreclosures. No important class can stand to one side and profit from the misfortunes of the other classes.

The interdependence of the members of society as consumers can be established by such general observations; but, perhaps unfortunately, people think more seriously of their interests as producers. It is, therefore, worth-while to inquire more precisely into the relations of people regarded as the possessors or controllers of the factors of production. From this point of view, people can be classified as workers, owners of natural resources, capitalists, and enterprisers. These factors and these people must all be involved in the act of production, and they must all draw their rewards from the common product.

## RELATED INTERESTS OF THE FACTORS OF PRODUCTION

It is important to recognize that there are certain laws of nature that control the output for various combinations of these

factors; and in a competitive society these natural forces are permitted to determine, in broad outline, the distribution of rewards. This seems to be a fair statement, even though there are many points at which we find it necessary or desirable to modify this "natural" distribution. We can, therefore, profitably consider the results of combining factors with a view to seeing to what extent the self-interests of the various economic groups are naturally allied and to what extent they are divergent.

The mutuality of interest of the contributing factors of production rests upon the fact that, when several such factors are combined, the productivity or significance that can be attributed to any one of them is enhanced by the amount and quality of the others. Thus, the share attributable to workers and paid to them under competition will, by this principle, be enhanced by a plentiful supply of resources, by a large supply of tools and equipment (capital goods), and by a large number of alert enterprisers seeking the services of labor and seeking to direct these resources most effectively. Likewise, owners of capital goods would find the goods useless in the absence of workers to use them and useless in the absence of resources upon which the workers and tools could be used; and the owners will thus benefit by a large and efficient supply of labor and a rich supply of resources. Enterprisers, too, find best opportunities and returns in a country where there is a good supply of willing and intelligent labor and an adequate supply of capital resources in the hands of owners willing to venture them. This important principle rests upon the fact that production results from the combination of factors. The output per acre of land is increased by the amount of labor that can be devoted to its cultivation, by the amount of fertilizer and tools (capital), by the enterprise of the entrepreneur, and by the skill of management. A similar relationship holds for the yield per worker or the yield per 100 pounds of seed or fertilizer.

The efficiency of an economy can be measured in terms of any one of these factors. For example, some students of agriculture point at times with admiration to the high output per acre of certain countries like the Netherlands and contrast our lower

rate of output unfavorably. But if we are more interested in people than in land, or in people as workers than in people as landowners, we should be more concerned with output per worker, than with output per acre; and on such a test our agriculture rates very high. Since our people are, to an overwhelming degree, workers at one level or another, we should be interested in the output per man or in the output per worker per hour. We, as workers in this country, are fortunate that the supply of the other factors of production—land, capital, and enterprise—are relatively large and relatively larger than in any other country. It behooves us, as the suppliers of services, to see that the supply of these other factors is maintained and increased.

The fruitfulness and *value of any one factor of production* and the prosperity of the possessors of it *depends upon the supply of the other factors*. This principle is in some respects the most important in the whole field of economics. Its general recognition in all its manifold aspects would probably do more than any other one thing to banish the conflicts of economic groups that create so much bitterness and discord in all modern societies.

But while this general principle underlies the mutuality of interests of the several groups, the relations of the factors of production also give a basis for some apparent and some real divergences in interest. The dual effect of this principle arises from the fact that, in the combination of the factors of production in the productive process, one factor which is relatively scarce will enjoy a relatively higher rate of return than the other factors. But to understand the significance of this statement, it must be remembered that scarcity in this case refers to the relative supply of one factor to the supply of others. The socially advantageous way of creating a scarcity is to induce a large supply of the other factors relative to the one in question. But another way, and sometimes it seems an easier one, is to reduce the supply of the factor in question. The former policy has, of course, the effect of increasing the total production, an objective in which the whole society is concerned. The latter has the effect of reducing the total production and merely increasing the share which the restricted factor receives.

These relationships can be illustrated if we conceive a pro-

ducing organization, be it a whole nation or a single farm, and recognize that it has available and is using certain amounts of each of the factors of production—land, labor, capital, and enterprise. First, let us assume that we are dealing with a whole country which is operating with a given supply of capital goods and given supplies of each of the other factors. We could imagine that the combined efforts will yield a certain number of composite bundles of goods which, in their proportions, approximate the relative desires of the community for different things. Then we can ask what the effect will be upon the total number of these units of product and upon the distribution of them if we increase the supply of any one of the factors. Under these conditions, it will generally be true that the total output of goods will be increased by increasing the amount of any one of the factors. But while added amounts of any factor will increase output, that increase will not ordinarily be at a proportional rate. Indeed, there are particular situations in which the added supply will increase the output more than proportionately; for example, when six men are indispensable to operating a machine, the employment of four to five men would not do the job, while the addition of a sixth man would make the product possible. Also, at the other extreme, so many workers could be placed on a plot of land that they get in one another's way; and thus the marginal ones would actually decrease output. But if we confine out attention to our assumed economy of a whole country and remember that labor and capital are, in total, very flexible and can be used in many ways, we do not, for our present purpose, need to concern ourselves with these two logical extremes.

In the actual situation that confronts a country, we can always use more of the productive factors to advantage, even though—*if* the other factors do not also increase—the resulting addition to output would be at a declining rate. For example, if the country is operating with a limited supply of capital and a sufficient supply of the other factors of production, and it increases the supply of available and employed capital, the total output will surely be increased. But this increase will be somewhat less than proportional, which means that a 10 per cent

increase in the total supply of capital will yield an increase in production of somewhat less than 10 per cent. If all of the factors could be increased by 10 per cent, there is no reason why the total production should not also be increased by that amount.

If the increase in the amount of capital could be accompanied by new inventions or innovations (which would make possible a better utilization of the additional capital), then the tendency for the rate of added output derived from the use of this additional capital to decline could be avoided. This observation emphasizes how important it is for the possessors of any one of the factors of production, or for the possessors of all of them combined, to encourage invention and innovation, especially in an expanding economy. However, in order to see the effect of an increased supply of any one factor relative to the other factors, we shall assume for the moment that there are no changes in the techniques by which the factors are used.

The significance of this declining rate of addition (marginal product) is that there is a tendency, under competitive conditions, for this marginal product to determine the rate of reward for the factor being considered—not only for those additional units, but for all of the units. The reason for this is that the amount of production attributable to the one factor is determined by this marginal production. To say that an amount is *attributed* to one factor is not equivalent to saying that that is what the factor *produces*. When several factors are all essential to production, it becomes a metaphysical question of which factor produces more; it could be argued that any one factor produced all, because without one of the factors nothing could be produced. The case for labor being the sole producer rests basically upon this flimsy ground. This point could just as easily (and just as falsely) be made on behalf of land, capital, or entrepreneurs. For this reason there is little sense in trying to place a value on the *total* supply of land or labor of a country. We quite properly think in terms of units; in other words, we think in terms of more or less. Employing this "more or less" concept, we can ask how much more of output could we get if the country had a million dollars more of capital to use with the

existing supply of the other productive factors. If we conclude that the added output would be worth $50,000, we could say that that much should be "attributed" to that unit of capital and that is what we could afford to pay for its use. But since that unit of capital is no different from others, that would tend to fix the value of all capital, namely, at the rate of 5 per cent. (One could as well, perhaps better, inquire how much we would lose in total output if we were deprived of the use of that block of capital.)

From this line of reasoning we can say that an addition to any one factor will have certain results. First, the total output will increase. This increase in total output is obviously advantageous to all, partly because increased supply of this factor is equivalent —in its effect upon the relative position of the factors—to an increased scarcity of the others and to an increase in their marginal significance and partly because, as consumers, everyone in the community is benefited by increased production. Second, as remarked before, the increase in return will be slightly less than proportional. Why should it not be in direct proportion? Chiefly because the community had presumably, and if it had been acting sensibly, applied the old supply of capital to its most important, i.e., most productive, uses; hence, the new units cannot add quite so much as the former ones contributed. Why, on the other hand, do we think that the increase would be *nearly* proportional? Because, in a whole society, there are so many and varied uses for any factor and so many possible combinations of the factors, that ways can be found of using additional units almost as effectively as the units previously employed.

Third, the decline in the marginal product attributable to this factor will tend to make the reward per unit of this factor slightly lower, if the other factors have not increased at the same time. This conclusion has a direct bearing upon a conflict of interests between the possessors of different economic factors and between the suppliers of the previously used and additional units of this factor. Assuming that we cannot increase the other factors and thus avoid this decline in marginal productivity and reward, there would be a tendency for those already established units to try to prevent the utilization of additional

units. However, any gain made by the possessors of the previously used units through such restriction would result in reduced production, which would be generally harmful. Those who are harmed will be the possessors of all the other factors of production, whose output and marginal significance are thereby reduced, and also the possessors of the additional units, which will be left unemployed.

Fourth, in a large community the total amount paid to all the representatives of the factor in question will be increased, because in these circumstances the decline in rate will not be so great as the increase in the supply of that factor. Thus, the total amount paid to capital, if that is the variable factor—or in wages, if labor is the variable factor—would be increased, despite a slight decline in the rate of reward. The workers of a country as a whole, for example, will always be benefited by the complete employment of all available workers; and if they or their leaders think in terms of the total labor supply, there is no basis here for a policy of restricting employment. (It should be emphasized that this conclusion applies to a broad factor of production as employed in the whole economy, and we shall note later that a different conclusion may be drawn from the employment of a highly specialized factor in a particular occupation.)

A general conclusion is that the workers, landowners, capitalists, and enterprisers all benefit by an increased supply of the other factors; and each category, when viewed as a total class, benefits by its own full employment. The benefit in the latter case, however, may be at the expense of the per unit rate of return; and this provides a basis for efforts on the part of the existing members of any group to restrict the supply of that factor. Even this observation, however, does not provide a basis for conflict between economic classes; for the restriction suggested by it is against other members of the same economic group. Conceiving the factor as broadly as we have here, it is never an advantage for capitalists to reduce the supply of labor or for laborers to restrict the supply of capital. On the contrary, while the presently employed workers may not look too happily upon an increased supply of workers, nor capitalists upon an increased

supply of capital, they will both gain by and should welcome an increased supply of the other. Hence, while there is a basis for conflict of interest in this situation, the basis of conflict is quite different from that pictured in the socialist doctrine of the opposition of interests of the different economic groups and of the class struggle. If capitalists view their interests correctly, they find their best allies among workers, and workers find their best allies among capitalists. An attitude, then, of solidarity of members of one group as against others must be based upon an ideology or upon emotional grounds which have little foundation in economic realities.

## CONFLICTS CAUSED BY SPECIALIZATION OF FUNCTION

We have seen that the representatives of one factor of production in our national economy might have some ground, although a slight one, for attempting to restrict the supply of that factor. For example, there is an economic basis for laborers striving to restrict immigration, which would increase the supply of labor, or to prevent the employment of potential workers already available; but this is countered by the important consideration that the total wage payment in the country would be reduced by such restricted employment. In the former case (immigration), this consideration will not carry much weight, because the would-be immigrants are not among those whose interests are in mind in the formulation of national policy. But that is not (or should not be) true of potential workers in the country. These conclusions seem to be correct when applied to a broad factor in a whole economy.

But another fact which tends to explain antisocial restrictionist policies is that, in the actual world, these policies are commonly not applied to a broad factor in the whole economy, such as labor in general, but to certain specialized groups operating in particular situations. If we consider the effect of increased or decreased employment of a certain factor of production in such a particular situation, it appears that there is a stage in the increased use of such a factor in which the productivity curve (a term describing the added production from the use of added units of a factor) would decline very sharply. This

sharp decline expresses the fact that added units contribute added product at a sharply declining rate, in contrast to the very slightly declining rate which would apply to a broadly defined factor in the whole economy. To visualize such a particular situation, suppose that in a certain area or in the employ of a certain company 1,000 trucks are available for hauling gravel. And let us try to imagine that this enterprise is isolated from the rest of the community so that wages are paid on the basis of productivity in this project. In short, this is the whole society in miniature. Now, if we start with an available supply of 500 truck drivers, and if we assume that each truck and its driver can haul in a given time and for a standard distance, one ton of gravel, we would have an output in that time period of 500 tons. Under these circumstances, if the variable factor (truck drivers) were increased by 100, there would be 100, or nearly 100, tons added to the product; and this proportional, or nearly proportional, addition to the product accompanying increased use of the factors could go on until we had 1,000 drivers. Then we would have one driver for each truck. An addition of another 100 drivers would also add to the product, since some of the trucks could be used for more hours in the day; but this added product might be somewhat less than 100 tons, and so it would be with each added lot of workers beyond 1,000. When drivers had been added to a total of 3,000, we could perhaps operate the trucks on three shifts, but presumably with declining efficiency. Beyond 3,000 drivers, the drop in added output would obviously proceed at a very sharp rate.

If we assume that these additional men are versatile and that they could be added to the general force employed in the project—for example, to provide a few more loaders and a few more maintenance men, we can see that the output per man might decline but little. (If we think of our project as being the whole economy, some of the men could make more trucks; then there would be very little, if any, decline.) But if the men are specialized by virtue of their training, if their use in the other lines were restricted by the union rules in those other occupations, or if for any other reason their services had to be confined to the one task, there would be an obvious reason for those originally

employed to attempt to restrict the addition of men to a total of 1,000 and an even greater reason if the total went up to 3,000. With a sharp decline in the rate of additional output, not only would the hourly rate tend to decline, but the total wage bill of all the men as a group would fall, which is contrary to the conclusion reached for a broader group in the whole country. This result would follow because the marginal return in this situation would have declined so sharply that, when it was multiplied by even the increased number of workers, the total wage bill in that specialized occupation would have declined. This fact marks the distinction between the situation of specialized groups and of a broadly conceived group or the whole economy.

Under the circumstances applying to a specialized group of workers, to specialized forms of capital goods, to certain specialized types and locations of land, or to any other productive factor having a limited usefulness, the whole group of possessors of such a factor may find it to its interest to restrict entrance into the field or otherwise to diminish the employment of that factor. In the absence of such specialization, it would never be to the advantage of the *whole group* to restrict its own employment. Such restriction could only come about when enforced by some members of the group upon others, and then it would only benefit the former. Where labor is relatively immobile, either occupationally or geographically, there are two reasons for individuals or small groups to favor restrictive policies: first, their own value based on their productivity will be increased if the restriction does not apply to them; and, second, the total reward to the class—for example, the total wage bill to a trade—also would be increased. This special case has considerable practical importance because, as a matter of fact, most instances of concerted efforts to restrict employment are made by specialized groups rather than by very broad ones. This statement applies not merely to labor but to the other factors as well.

The restricted output may come about indirectly as a result of price advances as well as directly from the application of policies of restricted employment. A union may restrict employment with the hope of raising wage rates, or it may raise wage rates directly as a result of bargaining; and the higher wage, if unac-

companied by higher productivity, will raise the price of the product. To the extent that the demand for the product responds to price, this latter device will reduce demand and hence output and employment in that line just as effectively as would the direct approach. Thus, from the point of view of general social consequences, restriction of output can be accomplished by direct restriction upon the use of a productive factor or by overpricing that factor. People who generally condemn featherbedding tactics or restriction upon entrance to a trade, but who at the same time see no objection to an organized group forcing their wages to any level obtainable, are concerning themselves about direct effects only, although the indirect effects upon output may be even more serious.

We should notice how this cause of conflict of interest between special groups and the whole community feeds upon itself. A specialized group easily comes to a stage, in the increase of its numbers or in the number of hours of its work, where its own productivity declines sharply. To avoid that result requires that additional workers, regularly or occasionally, find employment in other lines. But if the workers in those other lines also face the same problems, they will be prompted to impose their own restrictions upon entrance to their trades. Hence, the more we confine workers (or any other factors of production) to special lines by any devices, the more necessary it becomes to restrict the workers or the hours worked all around. In short, immobility encourages restrictions on employment in a line of work; and restrictions in that line encourage seniority and other devices which increase immobility in the others. The fact that we have used labor as an illustration does not imply any invidious distinction. Similar restrictive practices are found in many fields. Antichain store laws, onerous restrictions on entrance to professions or on interstate movement into certain professions, local building codes which at times are alleged to protect local contractors, and practices in some business lines to prevent entrance of new firms—all these and many others are aimed with more or less success at the same objective of reducing mobility.

It is sometimes said that such restrictionist policies carried

out by any group reflect a deplorable lack of understanding of sound economics. In a broad sense, considering all the ramifications and possible retaliation, this may be true; but regarding the immediate effects, it is not easy to demonstrate that such policies are stupid. But if there is this basis for restriction, and if it cannot be banished by enlightenment, how can society function at all? Why doesn't each group strive for scarcity and thus ruin the whole common effort or so seriously impair the effectiveness of the free system as to make it untenable? Indeed, we have no assurance that that will not happen. The main reason it has not happened in the past is the difficulty of attaining group action. Landowners, for example, might like to see fewer acres of land or fewer city lots made available for use. But no single landowner would find it profitable to contribute to that desired end by reducing the amount of his own land offered for use.

So far, we have been concerned with the efforts to limit employment in order to affect the relative positions of the different contributors to production. But, in addition, those who control one factor of production may aim to increase the value of the completed product by restricting the employment of that factor and thus, quite aside from the question of the share of the production attributable to that factor, increase the value of it. For example, if the barbers or the construction workers in a community can restrict the amount of the end product in those occupations, they may be able to increase prices of them and correspondingly to increase wages. In these cases, a conflict of interest may not appear between the employers and the employees because the employers, too, may find it to their advantage to restrict the amount of capital and other resources used in the particular industry or in a particular locality of that industry. The conflict of interest in this case may be between all the people engaged in a particular industry and the consumers of the community. In other words, it becomes a clear case of monopoly advantage.

But whether or not the employers see eye to eye with the workers on this point (and apparently they have been in accord in the construction industry in some communities), it may still

be attractive for the workers to force wages to arbitrarily high levels with the full understanding that that will increase the price of the product. In such cases the employers may not resist very vigorously if the high wage has been imposed by industry-wide bargaining and applies to all competing employers alike. In any event, whether welcomed or opposed by the employers, the high wage may be passed quite directly to the consumers of the product. In a country in which by far the largest part of production is bought by other workers, gains made in this way are primarily at the expense of other workers.

For example, suppose that the soft coal miners restrict production or raise wages, acts which make possible or necessitate a rise of soft coal prices by forty cents a ton. As far as individual consumption is concerned, soft coal is used chiefly by laborers for house heating. The average worker's family buys about ten tons of coal a year. Thus, over the whole nation, lower and middle class families (largely other workers), pay an added $4.00 a year for this gain to coal miners. The plasterers, printers, food processors, and others may try to correct this situation by reducing their own output or by raising their wages beyond levels justified by productivity; and the circle is completed when the coal miners build houses or buy newspapers or groceries. But with the completion of the circle, there is less of all these goods if the process has involved a restriction of output. From the point of view of our inquiry into real and supposed conflicts of interests between economic groups, it may seem strange that there is so little protest from workers as consumers against such tactics of other workers as producers. Probably one reason is that workers, like other people, are more conscious of their welfare as earners than as consumers; and the obvious solution is to follow the example of the others rather than to protest against it.

## APPLICATIONS OF THE THEORY

We now turn to certain observations designed to relate this theorizing more closely to the actual world of business. The first observation is that we have assumed a high degree of mobility of the factors of production and at least an approximation of

perfect competition. Thus, it has been assumed that no one will pay more for a single unit of a factor of production than that unit adds to output. Actually that precision of evaluation cannot be attained. For one thing, it is not precisely known, and, for another, there is a cost in labor turnover that makes it impractical to hire and fire day by day or, in some cases, even month by month or year by year. The employment of particular capital goods (machines and plant units) must be on long commitments. For these and other reasons, there will no doubt be long periods when each factor is receiving more or less than its marginal significance.

These facts and many others mean that, while there is a strong tendency or pull toward rewards based on productivity, there is room for bargaining at any time. This bargaining relationship is one of opposed interests. Thus, we have a variety of opposed interests and parallel, allied or mutual interests. A typesetter, for example, has a strong interest in encouraging a large supply of capital and enterprise in the printing business. He can well regard the employers as his best allies—much more so than other printers. That conclusion grows out of the interrelations of the factors described above. On the other hand, he is on the opposite side from the employer in the bargaining relationship.

Both opposed and allied relations are present at the same time in the actual world, and it is well that it should be so. A requirement of a healthy and productive society is that the bargaining relationship, which is so highly personal and exciting, should not overshadow and lead to the neglect of the mutuality of interests between workers and employers. A danger in this country today is that the former might lead to neglect of the latter. Because this mutual interest is so easily forgotten, it becomes a responsibility of statesmen, educators, and others in a position to influence public attitudes to keep it before all classes of people. Especially is such moral and intellectual leadership needed in time of general depression and hardship. But during such times the demagogues and politicians find it much easier to gain a popular following by fostering the oppositions of interests instead of emphasizing their mutuality. The opportunity for

using such tactics to advantage is one of the dangers in a democracy. To make the most mild appraisal of such tactics is to say that their employment establishes a line of distinction between statesmanship and demagoguery.

A second observation is that we have treated the factors of production in the usual sense of land, labor, capital, and enterprise; but the reasoning is not restricted to these large groups. Each specialized group can be regarded as a factor; in which case, a modern manufacturing project would involve hundreds of factors. For example, the variable factor might be the hours of service of typesetters in job printing establishments. Then the other factors, conceived here as being held constant, would include the clerical force, floor sweepers, foremen, buildings, sales force, and enterprisers—indeed, everyone and everything whose co-operation is required to produce the end product. This fact gives a broad significance to the principles developed.

A third observation is that our analysis of relations of the factors treated one factor as varying while others remain constant. This assumption is necessary to arrive at any conclusion as to cause and effect in this or any other field of reasoning. But it should always be remembered that the other factors do not have to remain constant; and they commonly do not do so. Thus, under this assumption, we have noted certain situations in which it is profitable for some of the individuals or for a whole category to limit the employment of that group or factor. But an alternative is to maintain a relative scarcity of one factor by increasing the supply of the others. For the term "scarcity," as applied to one factor, is relative, depending upon the supply of the others. A scarcity of truck drivers may result from restricting the number of them, but it can be accomplished equally well by increasing the number of trucks and enterprises using them. The special interests of a group regarded as producers will be served equally well by this latter solution. The same group regarded as consumers will be better served thereby. Also all other groups, i.e., the community as a whole, will be better served, whether they be viewed as producers or consumers.

As to the relations of the economic groups viewed as participants in the process of production, our major conclusion is

that their mutual interests are in reality more pronounced than their divergent interests. Each group ought, therefore, to be particularly solicitous about the preservation of the other groups and about the providing of adequate incentives for the others to play their roles in the combined effort to produce goods and services which the whole society needs.

## OTHER REASONS FOR CONFLICT

It should be clear, and as an intellectual matter it is clear to many, that the maintenance of a high level of business activity and a high use of our resources and high production are not the special interest of any one group to be gained by a crusade against some other group or groups arrayed on the other side. Why, then, is there so much disunity on matters of such general interest?

There appear to be two main reasons. The first reason is our general psychological tendency to personalize all issues (to which reference was made at the beginning of this chapter). A result of this tendency is to conceive that wages and prices are set by the personal whims of people; if they are set by men of good will, they will be good according to the individual's point of view; if they are set by bad men, they will be bad. A recognition of the basic idea of social science as a complex of causes and effects and of forces from which no single individual or small group can escape and, at the same time, a recognition of the extent to which individuals can and do control their destinies and the destinies of others is much needed. To attain this balanced concept of our system is an obvious role of education. We have a right to expect much improvement in this direction, both in secondary schools and in colleges and universities.

A second reason for disunity applies to the relations between producers (sellers) generally and buyers. It arises from the fact that, in our system of private trade, values are created by scarcity as well as by abundance. This fact is particularly noteworthy in the case of those products in which there exists an inelastic demand, that is, a demand which is relatively unaffected by price. Under those circumstances, it may well be true that a

smaller total supply of a product offered on the market will bring a higher total return than a larger supply. Statistical studies seem to indicate that this is true, for example, of certain staple agricultural products. In such cases the temptation for the producers to reduce output is very strong if they can act as a group.

This temptation to create values through scarcities arises with the development of a market economy as opposed to one of direct production for use. The pioneer who came into the Middle West and hewed a farm out of the wilderness would recognize clearly that the more he produced, the better he could live. He would not be troubled with the thought that, if he would produce fewer potatoes and other food products, he would be better able to support himself and raise his standard of living. That thought enters his mind only when he begins to exchange potatoes for other goods or to sell them for money with which he can buy other goods. But even then he cannot profitably follow this antisocial and unnatural policy if he must act alone, because the effect of his restriction upon the value of the restricted output will not be great enough to offset his reduced sales. The interest of the community in preventing its members from "ganging up" to control the supply is thus apparent. To prevent such concerted efforts to create scarcity is one of the major requirements of a society which seeks, at the same time, abundance and freedom.

While recognition of the common interests of all members of society in an increased supply of enterprise and the employment and production which that would bring is to be desired, it would be fruitless to seek complete economic harmony or to pretend that it exists. In a competitive society the normal opposition of buyers and sellers should be maintained for the health of the whole system. It is the effort of the seller to get the best available prices and of the buyers to resist efforts to raise prices that serves to maintain right prices, to keep costs down, and to impose a reasonable level of efficiency as the requirement for remaining in business or in a job. When that resistance is broken down or weakened, inefficiency, waste, and high costs creep in. The ideal of complete harmony of labor and management is not

only quite unlikely to be attained, but if it were, it would be disastrous for the consumer at whose expense the harmonious agreements would be made.

The economic harmony pictured by Bastiat and other writers in the early days of a free market system does not exist in detail between buyers and sellers; it does exist among all the members of society viewed as consumers. It is a pretty safe rule that policies that improve the lot of people as consumers will be socially good policies, for such policies must lead to more goods of the kind consumers want and at lower cost to them. To attain these desired results for consumers in a free enterprise system, we must have (1) people who produce and sell similar goods and services vying with one another (there must not be too much harmony here); (2) buyers of goods or services, whether ultimate or intermediate buyers, who put up reasonable resistance to the demands of sellers; and (3) adequate incentives for individuals to perform those services which society desires. To maintain those oppositions of interests as individuals and, at the same time, to recognize the interests of all in a fully functioning incentive system requires understanding and self-restraint, but so also does the maintenance of a free and democratic society. If we have the qualities to support the one, we should be able to meet the requirements of the other. Indeed, if we do not maintain the one, we probably cannot maintain the other, for a free market economy and a free society appear in the long run to be mutually dependent.

Our discussion of the conflicts of economic groups has dealt with the relations of the different factors which have to be combined to bring about production and the relation of the groups producing the different things which the members of a society require. This emphasis seems justified because it has attracted so much attention in recent years and because it involves the concept of the class struggle. In this phrase, the struggle visualized is between capitalists and workers, that is to say, between two important functional groups in the society. We have also noticed the relations of buyers and sellers of the end products.

But of course the members of the society can be classified into

other groups, and conflicts can also arise between them. In the great world society or in society conceived as Western civilization, there are conflicts of national interest. What we have said about the interdependence of people in a society characterized by division of labor applies also to people of different countries. The objective fact is that the people of one country advance in prosperity along with, and generally not at the expense of, the people of other countries. In this field, however, popular attitudes, or the subjective basis of conflict of interest, very frequently run counter to this fact of mutual dependence. The mutuality of interests between nations will be discussed in greater detail later; but here it can be said as a general proposition that, although there are genuine conflicts from a military and power point of view, from the strictly economic point of view of advancing the standards of living of the peoples of the world, national interests are much more allied than they are divergent.

Another cleavage is between the rich and the poor. Here again, if we think in absolute terms of the amount of goods and services enjoyed by the members of these two poorly defined categories, it may well be true that the reduction of the wealth of one group would not add to the wealth of the others. This conclusion is particularly justified in a dynamic and flexible society in which wealth comes from production and is used, to a large extent, for production. Admittedly, that is not always the case. Where wealth has come from inheritance and where it is based primarily upon the ownership of land and resources, it may simply support certain privileged classes, the members of which can disproportionately demand and receive products of the common effort. The merit of a capitalistic system in an industrial environment, as opposed to an agrarian economy, is that wealth is typically employed in the form of capital equipment which increases the productivity of the whole system and frequently adds more to the real incomes of the poor than to those of the rich. This particular conflict, however, is not to be so easily dismissed. The very concept of rich and poor is obviously relative. It is almost inevitably tinged with envy; and to some people to a very high degree, and probably to all people to some degree, the

attainment of satisfaction depends upon the goods and services which they enjoy relative to those enjoyed by others. In so far as this is the real nature of the rich versus poor conflict, it evidently can never be solved by economic means alone. This is a difficulty which so-called "welfare economists" are encountering, namely, that certain satisfactions arise only from having that which someone else does not have or, at least if one does not have something, from knowing that no one else has it either. One cannot say that the problem cannot be solved; but if it is to be solved, it must be through changes in fundamental attitudes, and thus it falls far outside the field of economics.

Another conflict is between people who are established in certain economic positions and those who would like to become established—a conflict between the "ins" and the "outs." It can be observed among people in all of the functional groups. Entrepreneurs who are established in a particular industry may form common cause against those who would like to break into that industry. Workers who are established in a trade frequently take the same attitude toward apprentices and others who would like to enter it. Even members of our most dignified professions frequently do not rise above this selfish attitude. This particular conflict is perhaps the most significant one from the point of view of a progressive society. Technical and economic progress always imperils those in established positions because progress necessarily involves change. This fact leads frequently to a demand for stability and security, too often mere pleasant-sounding terms which simply mean the preservation of the status quo and the checking of progress.

## CONCLUSION

An important requirement for ameliorating most of the types of conflict of interests is the maintenance of mobility. The "freezing" of positions in almost any group of individuals is likely to lead to dissatisfaction on the part of some of them because, according to any classification—functional groups, national groups, rich and poor, the "ins" and the "outs"—some will always be more favored than others. The dissatisfaction arising from that fact is greatly accentuated as the individual

members of any of these groups feel that it is impossible to break out of that class; and the dissatisfaction is correspondingly diminished if there is a high degree of mobility so that individuals will feel that, even though their present position is not the best, they have some opportunity to improve it by their own individual efforts. Various apostles of discontent have, for their purposes, wisely fostered the doctrine that men are irretrievably bound to a certain rôle; and that, more than facts and more than most other dogmas, breeds discontent, disunity, and an unhealthy social psychology.

That the emphasis has been placed here upon the essential mutuality of interests of the members and classes of the society seems to be justified, not merely by sentimental or moral considerations, but by the requirements of modern methods of production. For these require the combined efforts of various functional groups, and as a corollary they also require an all-pervasive division of labor which extends in ever widening circles through the functional and industrial groups and over wider and wider geographic areas. The "logic of the machine" provides a materialistic basis for the doctrine of mutual dependence, which for its spiritual value has been held up to mankind by the great religious and moral leaders of all times. It is more true, in a practical sense, today than ever before that one person or one group cannot live to himself alone. The poetic words of John Donne, written in the early seventeenth century, were thus more a prophecy of things to come than a description of his own times:

> No man is an Iland, intire of it selfe; every man is a peece of the Continent, a part of the maine, If a clod be washed away by the sea, Europe is the lesse, as well as if a Promontorie were, as well as if a Mannor of thy friends or of thine owne were; any mans death diminishes me, because I am involved in Mankinde; and therefore never send to know for whom the bell tolls; It tolls for thee.

# 13

## *PUBLIC POLICIES AND INCENTIVES*

We turn now to the general question of public policy in relation to the incentives upon which, in a free society, we must chiefly rely for the maintenance of an expanding economy. It is obvious that we cannot cover the subject thoroughly, for that would require a discussion of all of the policy questions which would have a bearing upon expansion; and this, in fact, means most of the debatable questions of policy in the fields of government, labor, and business. Our purpose will be, therefore: first, to suggest the general significance of the incentives approach for policy; and, second, in each of several major policy fields, to indicate in a broad way how the incentives approach would affect decisions without attempting to make detailed recommendations.

### THE INCENTIVES APPROACH

Questions of public policy are, of course, greatly influenced by the pressures of special groups. Giving some attention to the incentives for expansion may suggest ways in which the demands of special groups should be tempered even in the interests of those groups. And strong as these pressure interests may be, there are also statesmen, public servants, and leaders of labor and business who are conscientiously concerned with determining policies that will advance the public good. It may be objected that this represents a rather naïve faith; but at any rate, what is said hereafter is based on that assumption.

Among men of good will, there are many objectives which sometimes support one another and which sometimes conflict. There is, for example, the humanitarian interest in the well-being of the lower income groups. This humanitarian interest

may take the form of a desire to influence the distribution of wealth and income in the direction of a closer approach to equality. It may also take the form of a preoccupation with the problem of individual security, as in the case of social security legislation. Then, there is a sense of justice among policy makers. This is an objective which is peculiarly fruitful of dispute because of the difficulty of definition and the lack of any objective standards. There are other special objectives; in the field of taxation, for example, the objectives of providing adequate revenues for the government and distributing burdens in proportion to ability to pay (which is a special aspect of justice). There is the further very natural desire on the part of legislators and policy makers to obtain funds with the least articulate protest—to "pluck the goose with the least squawking." All these and others are among the objectives that influence the determination of policy.

A consideration of the incentives for expansion should suggest that another objective, if we wish to maintain a high level of productive employment, should be to create an environment which will provide effective incentives for the establishment of new businesses and the expansion of old ones. It is not suggested that other worthy objectives, such as justice and an equitable distribution of income, should be discarded. They must, of course, all play their part in our efforts to create the good society. But in view of the importance of production and the crucial role of enterprise in producing it, we must give greater relative attention to the requirements of adequate incentives than we have in the past. It can well be argued that even the most just and equitable distribution of income can still leave us in a poor state if the total amount of employment and the effectiveness of that employment yields an inadequate amount of goods and services to be divided. What we are proposing, then, is a hardheaded, pragmatic approach for social engineers to the problem of increasing the real national income, an approach which recognizes the facts of cause and effect in this field of motivation.

The implications which can be drawn from the incentives approach to the problems of an expanding economy can be

grouped under several heads, which will include reforms in a number of specific lines in public policy; but in a democracy these possible reforms not only must proceed from the intellectual processes of scholars and experts but must be based upon certain general, public attitudes. We have discussed several of these in previous pages. They include: a recognition of the mutual interests of the economic groups; the importance of production as the only basis for material well-being; the fact that this production depends not only upon how many of us work (full employment) but also upon how well we work (man-hour productivity); that restrictions of output either by private groups or the government are bad, that the main protection against such restrictive devices is the preservation of competition; that expansion of production and employment depends heavily upon the encouragement of enterprise; and finally that such encouragement requires the maintenance of incentives in the form of profit prospects and other attractions that have been noted. These, it seems, are fundamental concepts of a free enterprise system. Their acceptance and active recognition by the mass of citizens would provide the basis for improvements in our system in the liberal tradition.

## SCOPE OF GOVERNMENT ACTIVITIES

The role of government impinges upon businessmen and their confidence in the future in several ways. One obvious way is in the extent to which government determines the aggregate of the tax burden; another is in government's restriction of freedom of action; and still another is in the possible role of government as a more or less direct competitor.

There has clearly been a trend toward multiplying the rules and regulations of government in a number of fields. Much of this is inevitable. The more complicated a society becomes, the more necessary it is that government, acting in its minimum capacity of setting the rules of the game, must extend its field. The game today involves many more people and affects their interests in much more direct ways than in the past. Even if a government were completely committed to the preservation of individual liberties and individual freedom of action, it would

be necessary that the book of rules be expanded. These facts often create a necessity of limiting the immediate freedom of action of one in order to preserve the freedom of action of others. The necessity for sanitary regulations is a simple and obvious instance. There is nothing new or startling in this. The founding fathers of this government recognized that liberties had to be curtailed at some points to preserve them at other more important points. But there are certain other activities which are interpreted in some quarters as a tendency to go beyond these necessary activities of a government striving to preserve individual liberties and to enter a category of activities which are for the benefit of part of the people at the expense of all the people. The part of the people to be benefited may be a minority, and the possibility of getting support for such policies may arise from the familiar political practice of minority groups supporting one another in their individual ambitions.

It may be remarked, however, that the principle is much the same whether those benefited are a minority or a majority. If we start with the assumption that the ideal of a democratic society is to insure the maximum of individual liberties and freedom of choice, then it follows that, so far as possible, we should avoid governmental action, even for the benefit of the majority, if there is any feasible way by which the same ends can be attained through individual freedom of choice and freedom of action. The very essence of government is coercion, and coercion is clearly the opposite of freedom of choice. The government typically uses orders instead of persuasion, and the question of paying for supposedly beneficial services is not left to the individual who is expected to enjoy those services. It is sometimes said that, if there are certain things that the government can do better than individuals, that is sufficient justification for the government's doing them. But that leaves out of account the essential difference between a price and a tax. If, for example, such a laudable project as the maintenance of a symphony orchestra is being considered, there are two ways of supporting it. One is that those individuals who desire to hear an orchestra sufficiently to pay the cost of maintaining it should have the freedom to do so. Such an individual can exercise his

freedom of choice on two sides: first, as to whether he wishes to hear the orchestra; and second, as to whether he wishes to hear it enough to pay the cost. The other way is for the government to establish the orchestra, in which case the individual may possibly have the freedom of choice as to whether he will hear the orchestra or not; but if he is a taxpayer, he has no freedom of choice as to whether he will pay for it. Another way is for a philanthropist to provide the funds, but that really falls in the first class because the donor is free to spend his money in this or some other way. Now there are a number of activities in which such freedom cannot be allowed. For example, the maintenance of a public school system is an essential requirement of a successful self-governing community; hence we properly conclude that all members of the community should be required to support it as a consequence of being a member of society, but that is quite different from justifying the government action merely on the ground that the activity is regarded as a desirable one for the individuals of the society.

For one thing, to adopt this latter philosophy implies that there is someone who knows what is best for the individuals of the society. Throughout much of the history of the world, there has been the thought that the wise men knew best what the other people should have. For a number of practical reasons this philosophy came to be discredited. Aside from the practical difficulties of determining who the wise men were, there was no guarantee that they would always act in the public interest. There arose, toward the close of the eighteenth century, the more profound objection, namely, that the highest purpose of the society was to encourage the development of the individual as an end in itself; and that meant that individuals must be free, in so far as they do not interfere with other individuals, to make wise or foolish decisions regarding the direction of their efforts, the ends which they sought, and the means used to accomplish them. We should recognize that this philosophy has been relatively short-lived but that under it, in the Western countries and particularly in the United States, mankind has made tremendous strides. The greatest issue before the human race today is whether that liberal ideal is, after this short flowering, to

vanish from the face of the earth. All this is part of the outlook for the future and the prospects for liberalism or authoritarianism. While these factors may not consciously enter into the calculations of businessmen, they do, nevertheless, affect them, since they are a part of the psychological climate in which we move.

Somewhat more direct in bearing upon the prospects for business is a new attitude toward the public debt held in some quarters. As long as the extended activities of government had to be paid in the form of taxes and especially of direct taxes, there was always the resistance on the part of people to pay for what they did not want. This resistance, even though it came from minorities, was an obstacle; but now there are those who believe that they have discovered a painless and costless way of expanding government activities, that is, through the public debt, which is pictured as really not a debt at all as long as it is "owed to ourselves." Thus, a significance of this new attitude is in the possibility it has for overriding the obstacles to increased functions of government.

Businessmen are especially affected by such views. In the first place, they do not believe that the public debt can be expanded without a necessary day of reckoning; and if the debt is to be paid by taxes, they view themselves as the most probable taxpayers. In the second place, they are particularly concerned with the stability of government credit. This concern with the credit of their government is partly a matter of direct pecuniary concern to themselves; and it arises partly, no doubt, out of their preoccupation with solvency as an ideal. In the third place, they feel, rightly or wrongly, that extension of government activities, to be financed by a loose-money policy, will directly or indirectly constitute competition with themselves. This competition may take the actual form of the government entering into like businesses; or, as viewed by the businessman, it may merely represent a diversion of free purchasing power to the government treasury—a kind of competition for the consumer's dollar in which the tax collector has an obvious advantage.

In considering the problem of fiscal policies, the business

community is faced by a dilemma. Once a huge government debt has become established, as it has in this country, there is the alternative of meeting its obligations and perhaps reducing the amount of the debt or neglecting to do these things. If the obligations are really met, that means high taxes. If the obligations are not met, that means an impairment of government credit. If they are met by the device of encouraging a rise in the price level, that has its bad direct consequences and the indirect effect of impairing confidence in the good faith of the government. Either of these methods constitutes a serious deterrent to enterprise. It is an unanswered question whether a lukewarm or equivocal attitude toward meeting the government's obligations would, in the long run, have a worse effect upon business confidence than would the high taxes which would be necessary to carry out the other policy.

On this attitude toward fiscal policy, it is also notable that the enterpriser's reaction is determined not merely by the amounts of the debt but also by the purpose and philosophy which he sees, or thinks he sees, in it. The huge additions to government debt to fight a war which was forced upon us are quite differently regarded and probably have different effects than a smaller addition to the debt for some purposes regarded as less justifiable.

In all of this, emphasis has been laid upon the attitude of businessmen toward government expenditures; and that is where it belongs, since, in dealing with human motivation, attitudes are more important than objective facts—or stated otherwise, objective facts gain significance through their effects upon attitudes. Because this is the case, part of the fault may lie with businessmen themselves in taking an unreasonably suspicious attitude toward some of the activities of the government; there is no question, as we said before, that government functions must increase; and perhaps there has been a failure to discriminate between those necessary and justifiable extensions of government and those which really do represent a tendency toward collectivism. We need, then, a more intelligent understanding by businessmen of the legitimate increased responsibilities of government; and we need a more intelligent and sympathetic

interest on the part of government in the fostering of free enterprise. It is certainly the height of folly for a government, whose concern is the welfare of the whole community, to work at cross purposes with, if not with hostility toward, the very group of people who are most responsible for initiating and directing the economic activities of that community.

## EDUCATION

Closely related to the matter of public opinion is education, which in this country, because of the increasing number of years spent in the schools and the increasing attention given to economic and social questions, is coming to have increased importance in the molding of public opinion. That we need more general education on economic fundamentals seems to follow clearly from the observable facts that economic illiteracy in this country is appallingly high, and that in the field of economics, every man seems to be willing to act as his own expert. One could wish that the problem were simply to have more attention given to this field in the secondary schools and popular education. But one's ardor for that solution is cooled by the fact that too often such an increase in instructional time for these subjects is largely devoted to the discussion of current events, and to the premature consideration of complicated problems by unprepared students. The result is likely to provide some opinions of current problems with no understanding of generally applicable principles. This is not an unavoidable weakness of secondary or of popular education in this field. It is quite possible to teach very young people some of the basic principles of economics, a recognition of which would be immeasurably valuable to them as citizens. Among such fundamentals should be, first of all, an emphasis upon and demonstration of the relation between production and consumption and the importance of the productivity of the individual workers of a country for a high level of wages and the maintenance of a high standard of living. It can also be made clear even to very young minds, how the various factors of production contribute to a high productivity and to economic well-being. It can well be shown how the various participants (those who supply the labor, do the directing, and supply the

tools) are all mutually interdependent. Unfortunately, I believe that much of instruction at the secondary level of education leaves the impression that the economic problems of the country are primarily those of conflict between one class and another. These objections are not intended to minimize the importance of the development of critical faculties nor as an argument for complacency and national self-satisfaction. There is plenty of room for reform in the economic system, even though one recognizes the simple principles upon which that or any economic system rests, and, of course, the objectives of education should vary with the age and previous preparation of students. But it is intended to suggest that, in a democracy, a major function of education should be to unite rather than to divide, to breed tolerance and mutual respect instead of class or individual dissension; and these objectives are especially pertinent for secondary and popular education in this country.

Professional education for business at the collegiate level can also have an important bearing upon the supply and quality of enterprise. This effect in the future is likely to increase because of the large and increasing numbers of young men and women passing through these schools and also because of the higher proportions of these young men and women who will become influential in the direction of our enterprises. Formal study and preparation for business (a field which has previously relied almost entirely upon apprenticeship) will presumably improve the quality of business management in this country and should have a desirable effect in reducing the mortality in American business.

There is, however, a serious danger in such formal education in that it may place greater emphasis upon the avoidance of errors than it does upon the creative aspects of business leadership. Our departments of English literature and music have been more notably successful in turning out superior critics and analysts than they have been in turning out novelists or composers of symphonies. The instruction in business administration, likewise, tends to emphasize the critical and analytical abilities and, thereby, may unwittingly develop a degree of caution which is consistent with the conserving of existing

positions but which is not so well adapted to adventure or to the creating of businesses. The greatest challenge which faces these schools is somehow to perform successfully the job of disciplining the minds of students without dampening their initiative or discouraging their natural tendency to adventure and enterprise.

The importance of these two levels of education can hardly be overemphasized, for the full employment of our resources depends, I believe, even more upon the philosophy of the people and especially of our young men—upon their courage, their preference for progress over security, and their mutual respect and consideration—than it does upon purely economic factors.

## REDUCING RISKS

The amount of expansion of business necessary to maintain full employment of our resources requires investment extending over a considerable period of time. It is true that some use of funds requires no very long look into the future. But for a healthy economy, we must have in addition the building of plant and the purchase of new equipment. Such ventures require a consideration not only of the current situation but of the probabilities over a considerable period of time. Thus, the requirement for a healthy economy can never be met merely by creating favorable present circumstances.

The best possible situation, from the point of view of this long-time investment, would be one in which the prospects for the long future appeared to be good. But traditionally in this country, business decisions have not been made on the hope of positively improved environmental factors of this kind but have rested merely upon a belief in stability in tax forms and rates, government regulation of business, and such fundamental institutions as the free market determination of prices, wages, and other costs. However, there are situations in which stability alone would not be adequate for the desired expansion and production. It is an exaggeration to say that business can successfully adapt itself to any kind of an environment providing it remains stable. For example, an unwise tax levied upon risk taking can bring about and perpetuate a low level of economic

activity. It is definitely not true that an old tax is always a good tax. Some taxes, if old, may be shifted; others may not be shifted, no matter how old; and in either event, the old tax may continue through its life to act as a brake on expansion. So, in spite of the advantages of stability, we can say that if an environment is unfavorable to expansion it should be changed. As to stability, we can only say that, all other things being relatively equal, a slow rate of change of conditions is to be desired. The problem is somewhat like that of the adaptation of a species to its environment. A species may adjust itself in time to an unfavorable situation; and in that sense, slow changes may be better than sudden changes; but that adjustment may be made by a reduction of the population of the species.

This emphasis upon stability of institutions does not extend, of course, to stability of demand for particular things. Indeed, it is the prospect of change and the varied judgment of individual businessmen as to the direction of that change that gives rise to much expansion. A situation, therefore, such as is provided by free choice of consumers and individuals within a basic environment and framework which remains stable, is best adapted to the encouragement of expansion.

Looking for a moment, not at the practical problems facing American businessmen today, but at the broader question of types of social organization, one finds much erroneous theorizing on the degree of stability that could be expected from an extension of what is commonly called "economic planning." It seems quite conceivable that a totalitarian state which expected to continue "for a thousand years" might follow such a consistent policy as to give substantial assurance for the future and, thus, to reduced risk. However, a perfectly free market, in which decisions are made independently by an infinite number of consumers, enterprisers, and workers, would also provide a basis for prediction because of the relative stability of large numbers and the possibilities of predicting what the mass will do, even though one cannot predict what any individual member will do. But an extension of economic planning *by a democratic state* runs the danger of losing the bases of stability provided by both of these pure types. In a democratic society, policies can rarely

be predicted for as long as ten years. No one in our government can pretend to speak for its really long-time policies, but sporadic changes and interferences with the working of a free market are common. That combination creates the worst possible situation for business predictions and, hence, investments. The question is thus pointedly raised whether this midway position is tenable or whether, for the making of those long-time commitments which a capitalistic form of production requires, we will be forced to choose between positions which lie reasonably close to the two poles.

Of course, we are not likely to move all the way to either extreme. If we do move toward a freer economy, there will still be the necessity of changing the rules from time to time. It is futile to say that we should not change the rules in the middle of the game, for the game of business has no definite beginning or end. If the rules are ever to be changed, as they certainly must be in an evolving society, they will have to be changed in the middle of some of the individual games. The reasonable hope of one who holds to the liberal tradition is that the changes will be gradually made and that due consideration will be given to the fact that institutional changes create uncertainty and impair confidence.

All of this is especially important in America, because changes induced by the free enterprise system itself are more pronounced and more rapid than in many other countries. These include the rapid changes in technology and the tendency, which has existed in the past and which has been commented upon so often by foreign observers, for American businessmen to adopt new machinery long before the old is worn out. The same can be said for the adoption of new methods of production, such as scientific management in its various phases. There is also the more rapid change in the economic status of individuals and groups and the greater willingness on the part of consumers to accept new products, new styles, and new ways of living. All of this means that, in spite of anything that can be done by way of stabilizing institutional environment, we will have plenty of changes and perhaps the maximum of uncertainty that long-time investment can tolerate.

There are those who argue that we should adopt new policies and new aims of government as a *means* of assuring stability—for example, that the government should undertake to underwrite purchasing power or to underwrite full employment. Such alleged attempts to reduce the uncertainties of business must be judged in the light of possibly greater uncertainties which the measures would create in other directions, namely, uncertainties as to government credit and to business taxes. In the present state of mind of American business enterprisers, such proposals appear to constitute new bases of uncertainty rather than of stability. There are some aspects of the economic environment in which the government cannot possibly avoid important effects. One of these is the price level; and in such cases, a definite policy of seeking stability would seem better than random fiscal decisions, which may definitely contribute to instability. We do not pass judgment on what the ultimate effects of such policies might be; but one cannot leave out of account the popular, though possibly ill-founded, reactions of investors and enterprisers to them. In this field of fiscal policies, it is peculiarly true that opinions held by a large number of men in strategic positions do, indeed, constitute facts. Whether those opinions will change in such a way as to make policies of this kind more palatable and less disturbing to the rank and file of investors and enterprisers, no one can judge at this time.

Profits are, to a large extent, a reward for risk taking. The greater the risks, the greater must be the profits in order to bring forth any desired volume of business enterprise and expansion. There are certain kinds of risk to which this relationship is regularized by accounting methods. The prospective rate of obsolescence of machines, for example, will determine roughly the depreciation charges which an enterpriser will set up as one of the ordinary costs of conduct of the business. Then, of course, there are the insurable risks, with which we need not be concerned here. These two types of risks which have a direct and quantitative bearing on costs also have a good chance of being reflected in prices. But the risks of institutional changes and perhaps the risk inherent in instability of the general price level do not impinge so directly upon prices. Nevertheless, risks

have their effect and they are more likely than those that can be regularized to cause a lessening of the supply of enterprise and, consequently, reduced employment. These risks, if they become too onerous, contribute to an equilibrium at less than full employment.

If one assumes, however, that somehow society is going to induce private enterprise to expand enough to provide full employment of our resources and if, at the same time, we are going to aggravate by political and quasi-political forces the uncertainties that naturally attach to business ventures, we must expect to pay a price in the form of higher profits. It is not customary (nor in most cases, proper) to think of profits as a cost; but if we assume the object of full employment to be seriously held by the community and if our policies do lead to increased risk, then it seems reasonable to conclude that, from the over-all social point of view, we must pay for those policies in the form of higher profits, derived from lower prices to the productive factors, higher prices for finished goods, or possibly subsidies. Conversely, we could expect, year in and year out, a narrowing of profit margins if risks could generally be reduced.

# 14

## COMPETITION AND ITS MAINTENANCE

In any kind of an economic system, and particularly in one which is characterized by a high degree of division of labor, there is evidently the need for a regulator to co-ordinate the activities of the many individuals and groups involved and to direct them to the ends which are desired by the members of the economic society. To some it seems that the most obvious way of meeting this requirement is to concentrate authority in some individual or small group and leave it to that authority to decide between the many conflicting claims and to issue directives aimed at bringing about desired results. Although this method may seem to be the obvious one, and it is approximated in such single purpose activities as the waging of a war, it is the antithesis of the method generally employed in a free market society. In such a society, with the preservation and healthy functioning of which we are concerned, the central regulating force is competition. In view of this key position of competition in our kind of economic society, it may seem strange that there is so much disagreement as to the nature of competition, its extent, and its probable future. To these and related questions, we turn our attention in this chapter.

### COMPETITION AND BARGAINING

The basic concept of competition is that of one person striving for some goal which is also sought by others. Thus, the user of raw materials may compete with others to secure them; the employer of labor may compete with others to hire that labor; a business concern may compete with others for a particular business site; and the consumer may compete with other consumers to secure goods. On the other hand, sellers of materials compete

with one another to dispose of the materials; owners of real estate compete with one another for securing tenants; workers compete with one another for securing particular jobs; and sellers of consumer goods compete with one another in trying to dispose of their goods. It is the efforts of sellers of various things and services to make sales and the efforts of buyers to secure goods that constitutes the regulator of the economic system; and it is the presence of rival suppliers or buyers that limits the power of any one of them to impose his will upon others.

In this view the central feature of competition is rivalry between the members of one economic group. The term thus describes a relationship which exists between the people who seek the same goal and whose interests as competitors are opposed.

There is another economic relationship which should be clearly distinguished from competition, namely, the bargaining relationship. When a buyer and a seller face one another, each of them has opposed interests in that the buyer hopes to effect the transaction at a lower price or to get a better quality or in some respect, a better "bargain," while the seller hopes to secure a higher price or to reduce the obligations placed upon him or in some other way to get a better bargain for himself. These two relationships are often confused. In bargaining it is implied that a considerable spread exists between the upper and lower limits at which the transaction may ultimately take place. The bargaining relationship is best illustrated by the position of a single seller of a horse and a single buyer. The buyer offers $100; the seller demands $200; and by the various arts highly developed among horse traders, a price may be finally agreed upon that is more favorable to one or the other. A necessary assumption, for such a perfect example of bargaining, is that there are few, if any, practical alternatives to the buyer and to the seller. In other words, to attain an extreme form of bargaining, there must be little competition between sellers of horses and between buyers of horses. If that competition does exist on the two sides, the practical range over which the bargaining could take place would be very narrow. In short, the more of competition, the less of bargaining. The two concepts thus, can be seen to be quite different; indeed, they are opposed.

People sometimes refer to the competition of labor and capital or of consumers and producers. It is quite evident that this is a misuse of terms. The buyer does not compete with the seller. He bargains with him; he competes with other buyers. The distinction has more than academic interest, for it is sometimes argued that what our economic system needs for its effective functioning is more bargaining and more "equitable" bargaining. It is sometimes implied that this is an aspect of competition. This confusion of thought arises, for example, in the discussion of collective bargaining. The fact is that collective bargaining represents an attempt to reduce competition between individual workers; and if it is conducted on an industry-wide basis, it will almost inevitably reduce the competition of employers. The contrast can be seen also if we look at the highly organized markets in which there is a free effort on the part of sellers of, say, wheat, to dispose of their product at best prices. In such cases, there is relatively little bargaining in the sense of negotiating price over a considerable range.

The confusion of these two concepts is shown in the popular view that, in order to determine prices, wages, or other matters equitably, the persons on the two sides must have equal bargaining power. What is frequently meant by this is that they must be equally wealthy and have an equal command of economic power. Such a nicely balanced situation would, of course, rarely arise; but it is not necessary that it should exist if we are placing our reliance upon competition. Take, for example, the situation of an individual housewife purchasing groceries from one of our large chain store organizations. Surely in economic resources they are no equal match, but our housewife is not defenseless by any means. She has the alternative of patronizing another vendor, either another chain store organization, or one of several other types of retailers. Her defense thus consists not in her own economic resources but in the rivalry between the sellers on the other side. The suggested solution often made, that the consumers must combine in order to present an equal power unit, is quite unnecessary as long as this rivalry of sellers exists. If the sellers were combined in one unit, that is, a monopoly, then an equal combination of the buyers might be called for.

Still another solution might be sought in the determination of the terms of sale by a central authority, presumably the state. But as long as competition actually exists, there is no need for this balancing of power units; for under competition, the weak are protected by the interrivalry of the strong.

Another reason for stressing this distinction is that, when competition is effective, the price and other terms of sale are more or less impersonally determined. While it is true that a price is offered by a particular seller (or bid by a buyer) and is personal in that sense, the influence of rival offers is so strong and comes from so many other decision makers that it is, in a sense, impersonally determined. Moreover, these forces tend to establish prices and other terms of sale in such a way that transactions do in fact take place. In the absence of competition, when the settlement must be reached by bargaining, a variety of forces are introduced, such as the ability of one party to hold out and to injure the other party by so doing. One of the results may well be that the transaction will not take place at all. Such a deadlock can have serious consequences in checking the production and flow of goods from producers to consumers. In order to break that deadlock and to preserve the welfare of the community, it may be necessary to settle the matter by authority on the basis of various concepts of justice or political expediency, or on other grounds. In any of these events, personal authority is substituted for the impersonal operation of the market.

Moreover, the two concepts imply different relations of buyers and sellers. The bargaining concept implies an opposition of interest between buyers and sellers; the competitive relationship emphasizes the opposition of interest between different sellers and between different buyers. At the same time, the competitive relationship implies that each factor of production is most interested in a large supply of the other factors and finds its best allies not among others providing the same or similar services but among those providing or representing the other factors.

## DIFFERING CONCEPTS OF THE TERM "COMPETITION"

Economists and businessmen frequently use the term "competition" in different ways. Economists, at least those of the

classical school, were prone to set up certain assumptions which would facilitate strict logical analysis, even though it was recognized that these assumptions differed in some important respects from reality. An instance of this is in the assumptions to facilitate the analysis of the problem of price determination in a competitive system. For this purpose it was assumed that a large number of producers were producing identical products and delivering them at identical times, places, and with the same associated services and that the only variable involved was price. This was a justifiable procedure for its purpose, just as it is justifiable for a physicist who is striving to deduce the laws of the pendulum or of falling bodies to assume an absence of friction, air pressure, and other disturbing factors.

While these assumptions are justifiable as a logical device for deducing certain principles, they are quite unrealistic in most cases and particularly in the case of manufactured goods; in the actual world of business, the shoes or the furniture or the automobile produced by the different sellers are not precisely the same, although they do serve substantially the same purposes; and if the consumer buys one, he will not buy the other. It is the opposing efforts of different manufacturers of radios to sell these slightly different products to prospective buyers that the businessman thinks of as normal competition. Indeed, in his use of the term, this rivalry is keener than that of the sellers of precisely the same things and when the other conditions assumed by the economist are present. Thus, the economist might offer, as the best practical illustration of perfect competition, the relation between wheat growers where the wheat is highly standardized and where there is a very large number of such growers whose products must be sold to a large number of buyers. But to the businessman that relationship is less competitive than the relation between one maker of toothpaste and another whose product differs somewhat.

He might point out that in the case of wheat farmers they do not act with any consciousness of rivalry. A particular wheat farmer will not be disturbed by the fact that his neighbor is increasing his production of wheat, because the production of

either of them constitutes an insignificant part of the total supply. Likewise, he will not be concerned if his neighbor discovers a better method of cultivation or harvesting. Indeed, if he makes such a discovery himself, he might pass it on to his neighbor farmer. The businessman would say that these farmers do not act toward one another like competitors, and he would point out that the conscious rivalry between automobile manufacturers on the points just mentioned is much greater. Thus, what the economist has chosen to call "imperfect competition," namely, such relationships as exist between the automobile producers, appears to the businessman to be the highest development of competition.

In some important respects the businessman's view is more nearly correct, or at least more practically useful; the rivalry of sellers with one another in most lines does not center upon one neatly segregated variable but includes all relevant elements of the transaction, such as quality, assurance, service, prestige of the producer's name, terms of payment, and so on.

We have noticed, then, that one way in which competition in practice differs from the perfect competition of economic theory is in the wide variety of qualities and types of goods which are vying for the consumers' favor. This fact means that price is not always the decisive factor, but rather that it is only one of several elements involved in competition.

## PRICE AND OTHER COMPETITIVE WEAPONS

Another bit of economic reality which has a bearing upon the extent of pure price competition is that many industries which fall short of monopoly are represented by only a few large concerns. This situation is technically called "oligopoly," that is, few sellers. A result is that any one of these concerns, in determining its volume of production or the price which it will ask for its products, must take into account the effect of those policies upon other companies and their probable reaction thereto, and finally, the effect of the policies of those competing companies upon itself. This situation breeds a sense of self-

restraint and of responsibility for the market, which an individual wheat farmer, for example, would never feel. It also has a bearing upon the form which competition will take.

A large manufacturer of cigarettes, for example, may hesitate to try to secure a larger part of the market by offering a lower price because he recognizes that his large competitors will be forced to meet that price reduction, and the result will be that the competitive advantage which he had hoped to gain will be very short-lived. (In this industry, it would probably not extend more than a few hours or a few days.) This does not mean that his competitive zeal is reduced, but rather that it will take some other form which cannot be so quickly copied by competitors. The manufacturer may hope that, by the time the new devices have been copied, he will have still another basis for competitive advantage. The effect of a small number of producers, then, has been principally to divert effort from price reduction (which can be promptly imitated) to other elements in which a competitive advantage can be hoped to be more permanent.

Besides a small number of producers in an industry, another factor commonly present in modern business that has its effect on the nature of competition is the presence of fixed costs. When production is carried on in expensive plants and with expensive machines, and when salaries and perhaps guaranteed annual wages create an important element of costs that do not vary proportionately with volume, there will be a strong urge to secure sufficient volume to keep that plant and work force completely occupied. Therefore, when total volume is insufficient to supply all producers, there is a strong temptation to improve one's own share by offering reduced prices. Not only do high overhead costs provide the incentive for seeking increased volume, but they encourage pricing on a basis of differential or direct costs, which of course are lower than total costs. But a moment's reflection will convince any producer that, since the same need for volume faces the other producers and the same possibility of pricing on marginal costs is open to them, they will probably meet any price reduction. Thus, the hope of solving the problem of needed volume in that way recedes into the background.

On the other hand, there are similar natural restraints against price advances. For example, if demand is adequate, a producer may believe that the market will stand an advance in price; but here, too, his self-restraint may prevent rash action, for under a competitive situation he has no assurance that his rivals will follow his lead, in which case, unless he is willing to operate at a price disadvantage, he either will not make the advance or will quickly drop back to the old price.

These conditions and forms of competition obviously do not conform to the pattern on which some of the older economic theorizing proceeded. But that pattern was never intended as a picture of the real world. No harm would be done by the artificial assumptions of "perfect competition" if it were always remembered that they were assumptions. But their use sometimes leads to the conclusion that the only useful form of competition is competition in price. Some economists have gone so far as to say that other forms of competition are "phony" competition.

The more realistic view seems to be that free competition of producers is the unhindered effort of each producer to get or to keep patronage which might go to another.[1] These efforts take the form of striving to make the offer more attractive to the buyers than the offers of competitors. This improved attractiveness of the offer may be a lower price; or it may be improved quality, a more attractive design, a more useful or attractive package, greater convenience of location of the point of sale, and assurance of dependability that comes from a long-established record, improved after-sales service—such as repairs or adjustments, and many other features that may be incorporated or associated with the product itself. In the effort to make an offer which will appear more attractive to the potential buyer than rival offers, another device may be to influence the consumer's desires. This introduces the arts of salesmanship and persuasion. All of these in this broader sense constitute competition. The different appeals mentioned constitute different weapons in the continual struggle to get and hold patronage. The

[1] This and other aspects of competition are admirably developed in F. M. Taylor, *Principles of Economics* (9th ed.; New York: Ronald Press, 1925), p. 26 and *passim*.

outcome will be determined by the composite attractiveness of all these features taken together.

In evaluating these offers, different consumers will attach different values to the individual features of them, and the whole market, i.e., the mass of consumers may attach different values at one time than at another. A practical result of this fact is that several rivals for the patronage of consumers may continue in business even though any one element, such as price, may differ among them.

Two consequences flow from such considerations: first, relatively infrequent price changes; and, second, among similar products, a high degree of uniformity of price. Rigid prices, referring to price through a period of time, and identical prices, referring to the relative prices of competing products, are sometimes offered by critics as evidences of collusion. But it appears that these results can be equally well explained by a high degree of sensitivity to the actions and anticipated actions of competitors, which is a feature of active rivalry. Indeed, it may be the knowledge that an attitude of rivalry and an ability to fight back exist among the others that discourages any one of them from making an aggressive price change; and if such a change is made by one, the conditions described encourage the others to meet it and thus to re-establish uniformity.

This does not mean that price changes will never be made. To illustrate, let us assume that we are directing the affairs of a company and that we desire an increased volume of sales. In the first place, we may believe that we can reduce price and that the others or some of them will not follow. These others may have sufficient volume at present, or they may believe that their product is sufficiently distinctive to bear a price differential without an undue shrinkage in their own volume. If we believe that to be their attitude, we may reduce price. The point is that, in this situation, we cannot decide the question merely by our own costs, prices, and needs; but we must try to anticipate how our action will affect our competitor's action. To carry the reasoning a step farther, we must bear in mind that our competitor's action will also be affected by what he thinks our subsequent

move will be. If, for example, he can be made to believe that our price reduction indicates a firm determination to keep one cent below him at whatever level, he may not retaliate at all.

Moreover, we may reduce price, even anticipating a corresponding reduction by our competitors, if we believe that the lower price will bring forth a sufficiently increased total demand to make it worth the reduced revenue per unit. (This, of course, depends on our view of total elasticity of demand.) We may feel that we and our direct competitors as well are threatened by newcomers in our price range or by an increasing popularity of products in a much lower price range which we would not ordinarily regard as direct competition. A manufacturer of standard brand cigarettes, for example, might consider that the price differential between the standard brands as a class and the "off" brands was too great and, therefore, take the lead in reducing it.

In such a game the actions of some will be more important than the actions of others. If an industry has one outstanding company in volume of sales, financial resources, prestige of its product, or other features, that one company may be especially watched by all the others and may, in fact, come to be recognized as the leader. This position may result from common agreement, but that unlawful collusion is not necessarily implied for the leadership may be established by the obvious facts of the industry. Such single leadership is often precarious; and more often, leadership exists merely in the sense that the one who makes a move is the leader at that moment if the others decide to follow. Moreover, it is not always the large company that initiates change. In some cases, the small or the weak are more likely to do so; they have less to lose, and their position may be more desperate.

A result of these conditions of competition, which in greater or less degree characterize the sale of most manufactured goods and services, is in some cases to induce less emphasis upon price as a competitive weapon and more emphasis upon other elements in the bargain, such as terms of sale, quality of product, form of package, after-sales service, and many others.

As to the social usefulness of rivalry which is conducted on the basis of price differences or upon differences in the other elements of the offer, there can be, of course, much difference of opinion. Some people believe that the most socially useful competition is that which centers upon price. An observation, however, of the past four or five decades offers considerable evidence to the contrary. This evidence lies in the great improvements of products which are available to consumers in these later years. It is true that striking examples could be given of reduced prices of such staple articles as are produced in identical form by many producers. But in a broad view of the standard of living of the American people, it is not so much these price reductions that have created, in a sense, a new world as the introduction of new things and the vast improvement in the old things. Automobiles, for example, are indeed cheaper than they were in the first and second decades of the century; but the most significant thing is that they are infinitely better, more serviceable products. From the mid-twenties to the middle and late thirties, there was little, if any, downward trend in the prices of cars that passed under the same names; but a comparison, for example, of a 1927 Chevrolet with a 1937 car of the same name at approximately the same price indicates a very great improvement in what the consumer could get for his money. In view of the fact that price is the relation between dollars paid and product received, it seems pointless to deny that the increase in that which is given by the seller can be as socially useful as the reduction in that which is paid by the buyer.

To this view it is sometimes objected that the consumer should have his choice between the simple and perhaps lower quality product at a lower price and the better or more refined product at a higher price. Actually, he usually does have this choice if the demand for such goods is sufficient to justify their production. The example most commonly cited in this argument is automobiles. Why, it is asked, does not someone produce a car stripped of all nonessentials and selling at a "really low price?" To this there are a number of answers involving the economics of automobile production. But perhaps the most pertinent one,

in its bearing on the nature of competition, is that the used car, in normal times, occupies this price class and is preferred by customers to a new car that could be sold at that price. In short, one of the important competitors which any automobile manufacturer faces is his own (or others') used cars.

Indeed, if we are to make a distinction between price and nonprice competition, one may argue with some reason that in a world of rapid technological change such as ours the concentration upon new and better products will yield even greater fruits than the efforts to reduce prices of staple goods—desirable as such cost-reducing efforts, of course, are. In a relatively static state of affairs or in a society which was largely confined to supplying the minimum necessities of life, the opposite conclusion might be justified. The outstanding feature of our society is the variety of goods available, the continual flow of new goods, and the improvement of old goods. Regarding an improved standard of living under our conditions, more may be expected along these lines than in the reduced price of wheat, lard, and staple cotton cloth.

This question has some bearing upon the alleged decline of competition. Whatever may have happened to the frequency of price change or to the uniformity of price, there can be no doubt that the efforts of designers, engineers, and market research men are even keener and more widespread today than they were in earlier decades. Moreover, these efforts have produced a much wider range of choice to consumers and thus have improved their competitive position. The same observation can be made even more strikingly concerning the introduction of new and radically different materials. The consumer of textiles, for example, in the early 1900's, was limited to a few staples which, because of their distinctive qualities and their wide differences in price, were, in effect, noncompetitive. Today, each of the old staples has effective competition in the form of rayon, nylon, spun glass and many other synthetics; and we can fully expect others to be added to this list. While it is true, therefore, that competition takes different forms from time to time and that it varies from one industry to another, there seems to be no reason for conclud-

ing that it is less pervasive today among producers or that its direction is less socially useful.

## GEOGRAPHIC INFLUENCES ON PRICE

Another consequence of these and certain other features of modern industry is a departure from the single price to all buyers which the assumed conditions of "perfect" competition would produce. Examples are in the differences in price or in net return to the sellers on sales made to customers differently located. A simple form of this geographic variation in the net return to sellers is created by so-called "freight absorption."

Let us illustrate how this practice develops by taking a hypothetical example.[2] Thus, suppose that a certain manufacturer of refrigerators may be located in Wisconsin. He is selling his refrigerators at his plant at $100. To this price, the retailers located at various points must add freight to determine the delivered cost to them. This is the simple F.O.B. price plus freight. His salesmen are in the field, and one of them approaches a customer at some distance from the factory—let us say in New England. He is able to interest this prospective buyer; but he encounters the objection that a New England manufacturer of a competing refrigerator offers the same F.O.B. price, but the freight is only $5.00, whereas the freight from Wisconsin is $20. The resulting delivered price differential ($105–$120) may be too great to permit a sale. This may well be true even though the Wisconsin product has some distinctive features attractive to this buyer.

Now, if the manufacturer is eager to make that sale, he might decide to absorb part or all of the freight difference in the latter case, by offering to pay $15 of the freight, thus putting his product on the same delivered cost basis as the New England product. But if he does this, he will have a "mill net" after

---

[2] The legal status of geographic price patterns is, at this time, a matter of litigation in the Federal Trade Commission and the courts. It would be impossible in limited space to present the details of such pricing methods and to discuss the cases in which these methods are used without the danger of unfairness to one side or the other. I have, therefore, applied the reasoning to a purely hypothetical case; and to make clear that it is hypothetical, I have selected a product in which these price patterns have not in fact developed.

his freight contribution of $85 on this sale, whereas he realizes $100 on sales to his near-by customers. He is thus differentiating between buyers in different areas.

From this illustration it can readily be seen how the practice has come to be called "freight absorption." Actually, that seems to be a misnomer. The fact is that the manufacturer finds that, when he moves out of his own market area (that is, the area in which his price plus freight determines the price to retailers), he encounters a different competitive situation—one in which he cannot get over $105 for the delivered product. He therefore reduces his price in that market to meet competition.

If it should be suggested to our manufacturer that he meet the situation by reducing his price at the factory to $85, he would probably reply that $100 is not an exorbitant price and, in view of his costs and freight charges, that $120 to the New England town would be reasonable. The fact that he cannot get that price in New England and, hence, takes the best price he can get is no reason for making a concession in Wisconsin.

It is clear that this is not what would happen under so-called "perfect competition." A single seller of wheat would not be likely to sell, at the same time, part of his wheat at net returns of $2.00 a bushel and the remainder at $1.75. He and the numerous other sellers would press their wheat upon the $2.00 market, reducing the price until it was all sold there or until the net return was as low as in the other market. Our manufacturer does not do that for a number of reasons. In the first place, he may be the only manufacturer in his area; and, therefore, he can fix his local price as he chooses, limited only by his judgment of the elasticity of demand and by the price at distant production centers plus freight to his area. In the second place, there may be a few other producers in his area. Each producer may be restrained by his awareness of the effect of his actions on the actions of his competitors, as explained above; or there may be a secret agreement on price which would lead to the same result. Moreover, such a manufacturer is well aware of his fixed and variable costs. The mill net of $85 may more than cover all direct (variable) costs and make some contribution to covering the fixed costs. He may reason then that he can take some busi-

ness at $85, but that he could not cover all costs if he sold all his refrigerators at that price, just as a retailer may sell goods during a bargain sale at a lower price than he could set for all his sales.

But while the actions of the manufacturer do not conform to the pattern of perfect competition, they are, nevertheless, competitive. The price made in the distant market was clearly dictated by his rivalry with the producer in that area. The manufacturer must also recognize that the New England producer either is invading his midwest area in the same way or may do so and that his own price must be low enough to discourage that invasion. Each of these manufacturers will prefer, of course, to sell near home where he can get his maximum "mill net." Each must keep his own mill price low enough to discourage, even if it is not feasible to prevent, the distant producer from taking some of these desirable sales. Moreover, in such products (differentiated, as refrigerators are, in form and quality), there will be the usual rivalry for presenting the most attractive offering to the consumers and to dealers. In our illustration, for example, the Wisconsin firm, if it can present a more convenient design, may not have to make the concession in mill net in order to secure the New England sales.

When the products in question are standardized (homogeneous), it becomes impossible to get more than the going rate at a particular market. Under these circumstances, there is no need of pondering the question anew each time a prospective sale is under consideration. The Wisconsin producer of such a standard product would probably fix a definite price formula, namely, to take the New England producer's price and add freight from that factory to the market in question. The only practical question for our Wisconsin producer is whether he shall try to sell in that market in view of the reduced mill net which will be yielded. When this situation prevails and this formula for determining the manufacturer's asking price has been established, the Wisconsin mill can be said to be operating on a basing-point formula —the basing point being the New England producer's plant. (Incidentally, the New England producer would not be using a basing-point method unless he, in turn, invades the Wisconsin

territory and employs a similar formula based on the Wisconsin mill or on some other point than his own mill.)

Basing-point methods are used in a number of important industries where products are standardized, where production points are variously located (scattered), where producers are relatively few, where transportation costs are a significant factor in delivered cost, where overhead costs are important, and where the elasticity of demand is low. Among industries having these characteristics and employing various forms of basing-point pricing methods are those producing the several iron and steel products, Portland cement, salt, hollow tile, and several others.

This very brief discussion of basing-point methods (which, in all its details, is a very complicated question) is intended to show another of the special forms which competition may take and how far it may depart from the pattern of so-called "perfect competition." But it is also intended to suggest that, although the pattern of prices and the combination of price-making forces depart from that theoretical norm, there may still be a high degree of competition. The manufacturer in Wisconsin and the one in New England are competing with one another for the patronage of buyers in their own areas and in the intervening points. They are clearly competing, as we have indicated, in quality of product or, if the product is standardized, in quality of service (promptness of delivery, terms of sale, readiness to make adjustments, presale and after-sale assistance, and advice in the use of the product) or in other special attractions appropriate in the individual trade which will advance the purpose of securing that patronage which might otherwise go to a competitor. But there is also price competition in that, if either manufacturer raises his price too high, he enables other manufacturers to sell in his own immediate territory without the necessity of their making a concession from their normal mill net return.

The force of this competition will depend upon the relative demand and supply of the product. During a time of depressed trade, when each manufacturer is especially eager to secure additional sales, each mill will be inclined to push its sales efforts

into territories farther removed from itself and closer to other producers, even though that does require the absorption of freight. When, on the other hand, as in the immediate postwar period, there was an acute shortage of goods, producers were inclined to confine themselves to their own territory—technically, their maximum mill net territory.

A related practice in geographical pricing is that of manufacturers selling at uniform delivered prices at any point in the country or in some large area, such as "east of the Rocky Mountains." Sometimes this practice is prompted by the fact that transportation costs are negligible in view of the value and weight of the product—jewelry, for example, but also, this practice is sometimes used where freight costs are substantial. In these cases, there is involved, of course, the same practice of freight absorption on shipments to distant points and the same phenomenon of varying mill net returns to sellers as we observed in our previous illustration, although the explanations for the practice may be somewhat different.

## VALUES OF COMPETITION

We have seen that actual competition, as it is known to businessmen, departs from the assumed condition of "pure" or "perfect" competition in a number of respects. The rivalry takes place as to several elements in the offer made to prospective buyers, not merely as to the price of the offered thing or service; regarding price itself, there is a degree of self-restraint in initiating price changes growing out of a conscious regard for the counteractions that competitors may take; and in the effort to extend sales in competition with sellers more advantageously located relative to the market, there is frequently a departure from uniform net return from all buyers which would be expected under conditions of perfect competition. But we have seen that these variations grow out of competitive forces, are, indeed, forms of competition, and do not provide any prima facie evidence of a decline in competition.

A genuine decline in competition, however, would be a most serious trend and would probably do more than any other one thing to bring about a breakdown or a slowing-down of the

system which has brought us to our present position as the most productive and most powerful economic unit in the world. The values of competition have been implied in our previous discussion. They relate to our effectiveness as producers and also to the other elements of opportunity and freedom which are essential to our concept of a good society. These values can be best summarized by recalling the central features of competition. It is the rivalry between people of one economic class to gain the patronage of those in another class or group. Among people who are free to direct their patronage as they wish, that rivalry must consist of efforts to offer a *quid pro quo* which will be attractive to the members of the opposite group—buyers or sellers.

This general statement suggests that the value of a competitive system consists in the pervasive and continuing efforts on the part of people generally, both buyers and sellers, to conduct their affairs in such ways as will be agreeable to those with whom they are dealing. More specifically, certain values of competition can be enumerated. First, a competitive system assumes and provides a great many centers of decision; each person must feel free under such a system to make his appeals to others on bases that seem best to him. Such a situation, therefore, makes for variety and presents the opportunity for testing the effectiveness and the values of different methods of production, sale techniques, and other elements of economic activity in the market place. It is believed that this principle of decentralization of decision making makes better use of the potentialities of an intelligent and imaginative people than could any system of centralized authority.

A special reason for assigning this value to diversity is our interest in economic progress. The ideas of new and improved methods of production or of new products to be offered do not occur to all members of the society at once; nor would all members of the society or even their common representatives in a planned economy be willing to adopt new methods or to offer new products. Under a system of decentralization, it is not essential that common agreement should exist. It is only necessary that a small minority should be genuinely progressive; the rivalry of the others and their desire to preserve their posi-

tion will force them to follow the more progressive leaders, even though if left to themselves they might prefer to continue in their old ways. Thus, the creative minority does exercise great influence over the majority. This is the basic reason why too much self-government of business or other devices by which the majority in any line of activity can impose their will upon the minority are dangerous to progress, in spite of supposed values which such devices have for stability. Examples of the influence of such an aggressive minority in a competitive society are numerous. For instance, the automobile industry came into existence, and has advanced, not by any general agreement of producers or of the whole society that this method of transportation had merit; rather, a few innovators who did not have to secure the approval of any responsible group could set a pace which the others had to emulate, in order to stay in the race. On this ground we expect a noncompetitive society—either one dominated by private monopolies or one controlled by a monopolistic state—to lack the progressive qualities of a competitive society. Particularly, according to this view, a state-controlled system is likely to be a conservative one—perhaps even more conservative than a system of private industrial monopolies, for such "monopolies" would at least face interindustry competition.

Second, under a system of competition, the most feasible way for a seller to advance his own interests is by producing more and better goods and services. It is true that in many situations the returns to sellers could be increased by creating scarcities as well as by striving for abundance. While the deliberate restriction of production and thus the enhancement of the value of the seller's product may be attractive to the sellers of that product, it is clear that, from the point of view of the society as a whole, such a program spells economic suicide; it is as true today as in the time of Adam Smith that the annual income of a country depends upon its annual production. The merit of competition in this respect is that it is unprofitable for an individual competitor to follow such a device. A competitive system, therefore, establishes a parallelism between the individual interests of sellers and the larger requirements of the society.

Third, the rivalry of sellers for the patronage of buyers and the rivalry of buyers for the patronage of sellers, although it does constitute strife in a certain sense, tends to remove conflict between the members of the different economic groups. Thus, rivalry eliminates or moderates the strife that would exist between such power groups as the mass of sellers and an organization of buyers. It is highly desirable that such clashes of power groups should be avoided because they breed disunity; and, moreover, a clash of interests between such functional groups does not provide any automatic way for the solution of differences. It may lead instead to an impasse in which production and economic activity may come to a stop. An example of such an impasse is presented in protracted strikes.

Fourth, a closely related value of competition is that it has the effect of limiting power. Under this system the power of any one seller, for example, to determine the conditions upon which the buyers will obtain his product is limited by the efforts of other sellers to gain the patronage of the same buyers. Likewise, the buyer—either the buyer of goods or the employer of services—will be unable to impose terms of purchase or payment which would be most agreeable to him because there are competing buyers or employers whose bids must be taken into account. Indeed, one of the ways of stating the essential feature of competition is that under competition every person must consider not only his own desires but the rival offers of others in his own economic group. Thus, the power of any one individual or group is limited by that of others: it provides the protection of checks and balances.

Fifth, at the same time that it reduces power, the principle of competition increases the freedom of individuals. It does this in two ways. On the one side, as suggested above, it increases the freedom of individual enterprisers to make offers that to them seem best; and, on the other side, it increases the freedom of the persons to whom these offers are made. This latter aspect needs particularly to be stressed because, in practice, freedom consists of the possession of reasonable alternatives. A consumer, for example, really does not enjoy economic freedom as a consumer if there is only one feasible source of supply. To give him freedom

as a consumer means that he must be able to choose between several alternatives. Whatever may be said for the technical efficiency of a monopoly, even though state owned and, therefore, presumably operated in the interest of the whole community, it is still true that the economic freedom of consumers is limited by such a single supplier. If that objection exists as to private monopolies, it holds even more clearly for the all-pervasive monopoly which would be represented by a state-controlled economy. In the former case, people would at least have the freedom of choosing between different sellers by directing their purchases to competing things. In the latter case, the same supplier (the state) would be supplying all the things.

Sixth, the necessity for direct state control is reduced, because competition, when it is effectively functioning throughout the whole society, provides a decentralized and impersonal regulation of affairs. The relationship between the existence of competition and the avoidance of state control should always be kept in mind. There are certain necessary economic functions such as the providing of incentives for effort and production, the determination of what products are to be produced and how much, and the allocation of society's resources to these different activities; and since an exercise of private power on these points would be intolerable, the preservation of at least a reasonable degree of competition seems to be essential if we are to avoid the alternative of extended power of the state itself. Society cannot tolerate any unlimited sovereign other than the state itself. Hence, if any important group is to be unrestrained by the forces of competition, the logic for state control of it is apparent.

What happens in practice when a genuine decline of competition takes place is indicated by certain periods in which the demand for goods and services of certain kinds is so keen that active rivalry on the part of the suppliers of those services is unnecessary. In the period of very active business, during and immediately following the war, a situation of this kind did to some extent exist. The attitude and services of taxi drivers, waiters, salespeople, service personnel, as well as of the larger business units, suffered a letdown which impaired their services to the community and which was to be explained by a decline in

the day-by-day rivalry for patronage. Incidentally, such an experience suggests a serious problem for a country which strives for full employment; and especially it has a bearing upon the thesis, advanced by Sir William Beveridge, that the ideal condition would be one in which there was continually a larger number of jobs available than there were persons to fill them. In view of the limitations of human nature, it seems inevitable that such a condition would lead to a widespread and continuous deterioration of courtesy, efficiency, and productivity. On such grounds it appears that the ideal of full employment presents its own problems just as does the unfortunate condition of widespread unemployment.

It appears that talk about competition representing an unworthy attitude of one trying to get ahead of his fellows, while co-operation is pictured as mutual helpfulness, is quite superficial, at least when applied to economic relationships. Economic competition does indeed imply rivalry; but it is rivalry to serve others. Co-operation, on the other hand, has in practice different implications. It may represent efforts by the members of one group to improve the quality of their services to the rest of the community. This is notably true in several of the professions. The co-operation of the scientific investigators, for example, in the medical field, is commonly directed to assisting one another in advancing the common cause. And in the field of business, the co-operation of cost accountants, market analysts, and industrial relations directors, may be directed to the improvement of their several arts. In these cases the mutual helpfulness is obviously socially beneficial. But in economic relationships, co-operation may also have a quite different meaning. If the retailers of a town develop a co-operative attitude, they may in their mutual helpfulness decide to close their shops for the lunch hour and on every possible holiday; they may reduce delivery services and possibly eliminate some other practices which are annoying to one another, such as occasional and sporadic price reductions. The mutual helpfulness, in short, may not extend to the consumers. Co-operation in these buyer-seller relationships may in practice be not much different from collusion. Paradoxical as it may seem, therefore, pervasive competition in the field of eco-

nomic relationships provides the best basis for mutual helpfulness.

*The ideal, then, of a free economy is that, as buyers, everyone should have alternative sources of goods and services, and, as sellers, everyone should be limited by the competing offers of others of his own class.* Of course, the principle can be stated from the other point of view too: as sellers, everyone should have alternative customers, and, as buyers, they should be limited by the competing bids of others of their own class. This is the essential framework of a free economy. It does not mean that every individual is free to impose his will; obviously, such freedom would restrict the freedom of others. It does mean that the individual has a number of effective alternative choices and that such restraints, as exist upon his own freedom of action, are imposed by the impersonal forces of the market. It need hardly be said that this, like other ideals, is commonly unattainable in its pure form. An economy, however, which is characterized by these relations and mainly regulated by them, deserves to be called a free economy; and when other forces are most characteristic and reliance for the protection of the individuals is placed mainly upon these other forces, the economy is no longer free. Whether, under the latter conditions, people can remain free in the sense that is implied in the terms "civil and political liberties" is another, though indeed a related, question.

## ROLE OF THE STATE IN PRESERVING COMPETITION

Unfortunately, a powerful set of forces is always working against the continuance of competition. These forces can be summed up in the general proposition that competitors do not like competition. That is because everyone desires both freedom and power.

An ideal situation from the purely selfish point of view of each individual in the society—be he a manufacturer, a retailer, industrial worker, farmer, or a college professor—would be to have all other people in the society competing for his products or services while he himself had no effective competitors. Unfortunately, this idyllic situation does not meet the test of universal applicability and is, therefore, quite out of the ques-

tion in a good society. The vision of it does, however, in part explain the commonly noted fact that people in all these walks of life are almost unanimous in their praise of free enterprise and competition as abstract and general concepts, but also that the same people are not universally unwilling to enter into agreements which would limit the freedom of enterprise and competition which they so strongly endorse in general terms. This apparent contradiction does not constitute any special criticism of these groups; for it is a common social phenomenon that people support principles in general even though they may be willing to violate them in individual instances. Indeed, social problems commonly arise from a general recognition of a certain policy necessary for all, combined with individual desires to violate it. A people's desire for freedom and their fitness for it can be measured by their willingness to confine the pursuit of their immediate and individual interests within the limits set by general rules of conduct, recognized as necessary for the general welfare. A special application of this principle is that the fitness of a business community to live under a system of free enterprise is to be judged by its willingness to submit to the rigors of competition.

Since the rivalry of the people of one group for the patronage of the people of another group, which is the essence of competition, is the one practical means which the world has discovered for giving us at the same time control and individual freedom, and since individuals, or at least some individuals, are perennially under the temptation to try to limit their own competition, it follows that the state in a free country has an important and positive role to play in the preservation of competition. This obligation of the government must be recognized by all members of the community.

If the businessmen of this country want a system of free enterprise, not only must they proclaim its merits in the abstract, but they must refrain from restrictive policies which are aimed at destroying competition; and they must, as a group, give their support to those efforts which are directed to the preservation of competition. In terms of practical policy, this means that the businessmen of this country must devote their energies mainly

to the discovery and exploitation of new and constructive ideas as to products and methods. They must remember that profits are the reward for superior methods of production and superior service to customers. It is better to put the proposition this way than to urge that businessmen refrain from combinations; for in the first place such overt efforts to eliminate competition can be left to the law-enforcing agencies; but in the second place if these positive and progressive attitudes of businessmen are encouraged, there will be less temptation to follow restrictive policies. Not only will there be less temptation to such policies, but there will be less possibility of enforcing them; the greatest difficulty of forming and maintaining such combinations is the insurgent forces of enterprising members of the group be they new or old companies. Such members are not going to be satisfied with the maintenance of the status quo. Fundamentally, a better way of getting a good lawn is to plant and to encourage sturdy grass than to try to dig out the weeds.

In detail, this positive attitude means continual alertness to new methods of production, new types of materials, new ways of selling, and the possibilities of attracting trade by lower prices. It means, in many industries, the expansion of research activities, increased attention to market surveys, and the establishment of special departments devoted to new product development. These and many other policies that will be suggested by them are today characteristic of our more dynamic industries. They mark the direction along which industry generally must go. It is not an easy road. It requires thought and originality, but it is the price that business must pay for freedom from the bureaucratic and other controls which it so roundly denounces.

The support of government in its policing role implies that businessmen should be more discriminating in their judgment of governmental policies. They may with good reason oppose those tendencies of the government to exert positive and directive influence, but they should distinguish those tendencies from the efforts of government to prevent the deterioration of competition. In the past decade there has been a tendency on the part of most businessmen to condemn that group of policies which is

loosely described as the New Deal. That is quite understandable, but they should recognize that the antitrust activities of the government were not a logical part of a program directed toward government or group control. The National Recovery Act seemed to fit into such a program much better than the rejuvenated antitrust program which also came in the 1930's. In short, governmental policing of industry to maintain competition and specifically the enforcement of the antitrust laws should have the support of thoughtful businessmen who are concerned with the preservation of free enterprise.

That antitrust laws have not had this support to the extent that might be desired is explainable, not merely by the thought suggested above that individuals often give lip service to a principle which they are not too loath to violate in particular instances, but also because antitrust activity to businessmen means concrete administrative policies carried out by specific individuals and applied to very specific cases. Many businessmen feel (and an unprejudiced observer must agree) that in the application of the antitrust program the prosecutor's desire to make a favorable showing often gives prosecution the appearance of persecution. A certain attitude of cynicism too often characterizes the work of the enforcing agencies. Cases have been brought to court, involving very great expense to the defendants as well as to the government, in which the layman can see nothing more than the normal working of business forces which lead to such results, for example, as substantial identity of prices for competing products. In these cases the businessmen involved, and others as well, are unconvinced that there has been any wrongdoing. Such prosecutions have tended to discredit the whole program in the eyes of the business community. There is also a feeling that the government is not consistent in its policy of attempting to check monopolistic tendencies and devices. It is observed, for example, that groups of people, such as some of the labor unions, do much more to check the free working of competitive forces than do businessmen; and yet they are rarely prosecuted. In one notable instance in which the Department of Justice did attempt such prosecution, its efforts were thwarted by judicial decision that the antitrust laws did not apply.

If, therefore, businessmen are to be expected to give their wholehearted support to the antitrust program, we must have a change of practical policies on the part of the government. The two aspects are related. If the government follows a more broadly conceived and reasonable, although not necessarily less vigorous, policy of administration of the antitrust laws, it will go far toward gaining the support at least of the more farsighted business leaders. If, on the other hand, that support is given, then one suspects that the enforcing agencies would feel less on the defensive, would find it unnecessary to resort to sensationalism, and would give more attention to the fundamental problems and practical possibilities of improvement than to making the headlines. As it stands, the appropriations for the various enforcing agencies are always uncertain and usually inadequate; and the enforcing officers may feel that it is incumbent upon them to show convictions and particularly convictions of prominent defendants. Finally, what is here recommended is a meeting of minds of thoughtful business leaders and the enforcing agencies. To bring that about will require mutual understanding and forbearance, but somehow it must be attained if businessmen and government wish to give practical effect to their avowed devotion to competition and free enterprise.

All that we have said on this matter of the maintenance of competition has been aimed at the maintenance of the normal and healthy expansionist forces of industry. If, in spite of the working of such forces, we still sink into cyclical depressions, some restraints upon competition may be called for. This concession does not imply a lack of faith in competition as the general and major directive force for our society, but it is a recognition of the fact that competition can at times (and in some forms) be too rigorous. It may be true that a vigorous outdoor life is generally conducive to health, but it is not inconsistent to say that that would not be the best prescription for a convalescent. At a time when economic activity is at a low ebb, unrestrained competition may lead to the pricing of goods on the basis of marginal costs. Companies which follow such a program are not likely to be in a position to expand. Indeed, they may not be able even to maintain plant and equipment. To attain

that moderation of competitive forces without going to extremes of restriction is, of course, not easy. Perhaps the best practical solution is to be found in the natural self-restraint of businessmen acting in their own interests combined with the requirement that they should not act in concert. It often has been noted that businessmen, acting under this influence, may not proceed to the extreme of so-called cutthroat competition. It is not a logically perfect solution; but in view of the legal and practical difficulties of administering a more logically perfect policy, this may be the most reasonable one. This solution would mean the enforcement of the antitrust laws as to collusive restraints and perhaps some other aspects of a positive program; but it would not call for an extension of the law to attempt to cover those policies which, though actually the result of individual business decisions, may to some degree resemble the results of collusion.

Furthermore, we must recognize that we do not have in the actual economy the conditions assumed to be necessary for perfect competition; and since those conditions are not present, it may be that a concept of workable competition should allow for some deviations in other respects. Professor J. M. Clark has put the point this way:

> If there are, for example, five conditions, all of which are essential to perfect competition, and the first is lacking in a given case, then it no longer follows that we are necessarily better off for the presence of any one of the other four. In the absence of the first, it is *a priori* quite possible that the second and third may become positive detriments; and a workably satisfactory result may depend on achieving some degree of "imperfection" in these other two factors.
>
> Suppose the first requisite is perfect two-way mobility of the factors of production, with no specialized and irrecoverable fixed capital. Granted this, an industry can stand the most rigorous conditions in all other respects. It may have a multitude of small producers, who produce a supply and then place it on the market for what it will bring instead of quoting a price and seeing how much they can sell at that price; and it may produce a standardized commodity, so that individual

> demand curves are infinitely elastic; but efficient producers will still cover their total costs of production. Take away the saving grace of perfect two-way mobility and leave the other conditions; let demand decline, and competition becomes too strong; you have a "sick industry" on your hands. Reduce the number of producers and let them sell on quoted prices and anticipate one another's reactions and you have a form of "oligopoly." Change one more condition, substituting a chaotically imperfect market in which irregular, temporarily secret and discriminatory pricing is the rule rather than the exception and you have (whenever demand decreases or fails to grow as anticipated) a situation tending strongly to degenerate into a cut-throat price war, driving prices below an efficient producer's total cost of production, though, if producers are few and large, this condition is not likely to be permanent.
>
> These examples . . . . point toward a thesis . . . . that imperfect competition may be too strong as well as too weak; and that workable competition needs to avoid both extremes.[3]

Competition as the mainspring and regulator of the economic system has been discredited in recent years in some countries. What of its future in this country? Such an appraisal of the future is primarily contingent upon the expansion of business. The tendency toward restriction is most pronounced at times when the volume of business is small. The sellers strive to divide an inadequate amount of trade, and workers turn to work sharing and other restrictive devices. Competition is a two-way relationship. The existence of competition is a healthful expansionist force, and expansion removes much of the temptation to restrictions. The maintenance of an expanding economy through the efforts of everyone concerned would contribute to a solution of the problem of restraints.

Competition is also fostered by new inventions and by new industries. It is fostered by the opening of new areas and by the increased development of areas, such as the recent industrial

[3] J. M. Clark, "Toward a Concept of Workable Competition," *American Economic Review*, June, 1940, Part I, pp. 241 ff. Also, on the merits of "monopolistic" competition see Sumner Slichter, "The Fourth *Fortune* Round Table," *Fortune*, October, 1939, p. 110.

developments in southern California and in our southern states. It is encouraged by new types of retail and wholesale channels. In brief, change of any kind in technology, in production methods, or in markets tends to stimulate competition and to make attempts to restrict it more difficult. Government should resist the pressure of existing producers and distributors to restrict such developments. The so-called "fair-trade laws" that have been passed by most of the states and antichain store legislation are cases in point. Lastly, the best safeguard of competition is free entry into established industries and trades; and this gives a special point to the need for encouragement of new businesses. If these and other dynamic forces in our economy are wisely encouraged or at least not restrained, we will have created the best environment for the continuation of a self-regulating system and for the attainment of the dual goals of economic expansion and freedom.

## BUSINESS POLICY AND COMPETITION

The existence of a few large firms which control the production of a large part of the product obviously has effects upon the type of competition which will exist in that industry. We have remarked that some economists take the view that such conditions lead to a decline of competition and that these and other forces, such as the technical requirements of large-scale production, create a situation in which competition has become outmoded as a vital force. Some who take this view believe that the only feasible alternative solution is in some form of socialism. Others, although not going that far, believe that this inevitable decline of competition points to a need for more governmental regulation, rather than to what they would regard as a futile effort to restore competition. If one grants the assumption that competition has so seriously declined and that this decline is based upon certain unavoidable forces connected with modern technology, one would be forced to accept one of these conclusions.

I believe, however, that these forces do not necessarily lead to a decline in competition but that such decline as takes place is based, more than economists usually concede, upon a funda-

mental change in the attitude of people generally and business executives in particular. This decline of competitive attitudes may arise from some of those deeply grounded and mysterious changes that have in ages past affected the general spirit, the "tone" of a people. True it is that civilizations, as well as nations, have lost at times their spirit of adventure and their aggressiveness and have, perhaps only after centuries, given way to other peoples or civilizations which were more characterized by these qualities. A reading of such a work as Toynbee's *Study of History* should remove any complacency that one may have concerning the permanence of these aggressive qualities in any race or people. But aside from such fundamental forces as these, there are other forces that are more subject to control. We have indicated that the modern corporation is a very different thing than is indicated by merely its legal forms. The large corporations of today are frequently controlled by a group of managers whose ownership interest may be quite secondary to their professional management interests. These are the men who, in many cases, run the corporations; in fact, in some cases, it is fair to say they are the corporation, dealing with their stockholders in somewhat the same way as they deal with creditors, workers, and customers.

In such a situation the degree of competition that will exist will clearly depend upon the aggressive and competitive attitudes of those managers. An industry in which the top management of the several companies is occupied by men of this aggressive nature will be a competitive industry. An industry, on the other hand, that is dominated by men who place security above progress and expansion is likely to be only mildly competitive; and the search of such men will be for ways of dividing the market and tempering the competition. This is merely another way of saying that economics is a matter of flesh-and-blood people doing things. It cannot be explained completely in such mechanistic or quantitative terms as the percentage of the industry dominated by the top three or four companies. The automobile industry is an example. Even though there are three companies which account for a very large proportion of the total sales, there is no evidence so far of a decline in competitive vigor.

If the question is raised, "Why should not these three companies agree upon a division of the market or upon a policy of withholding improvements or of raising prices?" the answer, from one who knows that industry, is that the men controlling it are not that kind of men. There are industries in which the degree of concentration is not nearly so pronounced but in which competitive attitudes are not very conspicuous. Some people would offer the railroads of the country as an example.

How can one explain such differences? An important reason is in the policies which the companies in different industries have followed relative to selection and promotion of individuals to positions of executive responsibility. If an industry is dominated by rules of seniority and, if not by such formal rules, then by conservative policies of promotion, it is likely to find sooner or later at the heads of its leading companies men who will be attracted by conservative and protectionist policies. On the other hand, if the companies, or even if one or two of them, follow a policy of selecting able young men for executive training and maintain a keen and even ruthless competition between those men for promotion, if the company offers high rewards to these men upon advancement to top positions, and if their promotional policies can be kept free of favoritism—if all of these things can be done, as they have been done in some cases, we will find at the top of such organizations, and in a position to determine their policies, the kind of men to whom aggressive competition is as natural as the more conservative policies are to men who have been selected on another basis.

If such policies are to be followed, the boards of directors, the top managers themselves, the leaders of labor, and others must recognize the danger of an excessive emphasis upon permanence of tenure, seniority, and other standardizing forces that are altogether too prevalent in industry today. These are policies which do not inevitably grow out of the technical requirements of large-scale production. They are, on the contrary, subject to intelligent choice. In short, if the American people and particularly those directing and influencing the business of the country maintain, in their own spirits, the competitive and aggressive attitudes of the past, there is no reason why competi-

tion, in its broadest sense of constructive rivalry, cannot continue under conditions of modern production and distribution.

## THE STATE AS SPONSOR OF MONOPOLY

We have said that one of the primary functions of the state in a free enterprise society should be to preserve competition. In fact, in this country the state makes a great show of doing this in one part of the system. But that is a small part of the whole economy, namely, businessmen or business concerns doing business across state lines. If that seems to be more than a small part, notice what is left out. As a practical matter, all of agriculture, all of industrial labor, retailers and wholesalers (except those doing an interstate business), manufacturers having only state-wide business, professional men, and personal service industries are omitted.[4] A farm co-operative, for example, even though its numbers represent 80 to 90 per cent of the national production, can apparently limit production and control prices openly and without interference.

This limited coverage of the antitrust laws is apparently due in part to the limitations of the statute and especially to its limitation by recent judicial interpretations and, one suspects, partly to the lack of enthusiasm for prosecuting some politically sacrosanct groups. But the important point is that, in very large areas, the government (using the term in its broadest sense of municipal, state, and federal government and the three branches —legislative, executive, and judicial) is not an active force for the preservation of competition. There are the public utilities in which we have deliberately, and no doubt wisely, decided that competition cannot be a sufficient regulator and in which public regulatory bodies, therefore, have been set up. But there are also many other groups, such as those named above, in which no substitute has been set up; and still no governmental effort is made to preserve competition.

Not only this, but the government acts to encourage group action that clearly constitutes regular and effective limitation of competition. Indeed, viewing the whole economic system and

[4] It is true that sporadic cases, such as one against the American Medical Association, have been brought in these fields; but, by and large, the generalization seems fair.

its varying degrees of monopolistic and competitive forces, it seems fair to say that the greatest force making for monopoly in this country is the government itself.

A moment's consideration will bring to mind the many cases in which the force of government, either by special permission, encouragement, or positive orders, tends toward limitations on competition. There are the protective tariffs to limit or exclude foreign competition and quarantine laws and other restrictions on foreign trade that have been used for this purpose. In agricultural production and marketing, there are the crop-limitation programs; price fixing by "floors" and parities; the permission, if not encouragement, of co-operative associations in efforts to control production, conditions of sale, and price. In the retail trade, there are the so-called "fair-trade laws" which make it possible for associations of retailers to force manufacturers to fix resale prices satisfactory to themselves and, thereby, to prevent new retailers from breaking into the field by way of price cutting. There are the fair-practice laws which require retailers to maintain certain margins set by law.

There are interstate trade barriers by which, in a wide variety of products and services, the producers of one state are protected from the competition of those of other parts of the Union. Then there is one of the most flagrant examples of monopoly privilege granted by the states, although it is, perhaps, more annoying than it is practically important. That is the discriminatory taxes on margarine designed to discourage the sale of an ordinary and wholesome food product for the benefit of a politically powerful group of producers of a competing product. The experiences of citizens being deprived of a satisfactory spread for their bread or of being subjected to the messy job of coloring the margarine for the greater glory and profit of the dairy industry should constitute an eloquent sermon on the advantage of a "natural system of liberty." There are the many cases of perversion of desirable regulation to such monopolistic ends as for example, the local building codes, which are ostensibly set up to protect the health of the community but which have become a powerful weapon for protection of local builders or particular building trades.

There is the whole field of collective bargaining of labor in which we not only permit individuals to combine to avoid individual price competition but by law actually require the buyer of such services to deal with such combinations, and, through administrative orders, tell him which group (if there be more than one) he shall deal with. One could go on at length with the familiar story of the exercise of monopoly power.

If these seem harsh words for certain forms of combination of sellers that have secured widespread approval, let us bear in mind that we are not giving a blanket disapproval. We should, however, recognize that the problem of monopoly is not confined to the few cases of big business which fall within the purview of the Sherman Act. It is shot through our whole system; and if we are to attain any consistent policy toward the maintenance of competition, we should recognize that the state, which in the concept of a free-market system, should strive to prevent its citizens from following their natural tendency to "gang up on one another," has, on the contrary, become a very potent influence for encouraging that tendency.

A recognition of that fact does not tell us what to do about it. There are, of course, imperfections in competition. When such an imperfection, which gives a preferred position to some members of the community, is discovered and becomes a political issue, there are two broad lines to follow: try to abolish it, or give a compensating advantage to others. It is politically much easier to do the latter; but if generally followed, that easy way out leads to a policy of special privileges for all—which really is a contradiction in terms. Even if this granting of new privileges to offset old ones is not followed to its limit, it may still so impair the working of our intricate free-market system as to bring it into disrepute.

In general, then, it should be recommended that, when special privilege appears, the effort of government should be to get rid of it rather than to try to compensate for it. Such a policy, of course, calls for a much higher degree of statemanship than merely striving to satisfy the demands of every articulate group. A reason for this is that those groups are nearly always groups of producers, and people are more sensitive to their interests as

receivers of money incomes than as spenders of that income. For this reason, people as consumers are relatively impotent in politics; and that is an important reason why government is so commonly diverted from its proper economic function of preserving competition to the opposite policy of limiting it. The main thing that government can do directly and positively for producers, which those producers cannot do as well for themselves, is to aid them in creating a scarcity of whatever they have to sell.

There is another group which unfortunately carries little political power; that is the potential producers. Particularly important for our present problem is the group of potential enterprisers. Ovbiously, being only potential businessmen, they cannot organize, nor can any census be taken of them. They include, however, unknown numbers of young men who are graduating from schools of business and who are faced with the choice of seeking employment or going into business for themselves, inventors, and present employees of high and low rank who would like to set up their own business. Any measure designed to ease the lot of those already in a business, trade, or profession should also be viewed in regard to the effect on these silent constituents.

Take, for example, the resale price maintenance laws which exist in nearly all states under the disarming title of "fair-trade laws." They are ostensibly designed to confer upon the manufacturer of a branded product the power to specify the prices at which *his* goods will be resold by retailers. In fact, through the power which organized groups of retailers can exert over the manufacturers, these laws are really a means by which retailers may specify and invoke the power of law to maintain retail margins which they deem satisfactory. This may be well enough for the retailers who are already in business or, at least, for a majority of them. It is sometimes argued that this protection of retailers from the rigors of price competition will make it easier for new retailers to enter the field, since the laws protect them from the price competition of the established firms. It seems, however, that a more important effect of such laws is to deprive potential retailers of a weapon which will enable them to get a

foothold. Price cutting, and especially local price cutting, has often been pictured as a device of existing firms for preventing the rise of new ones. In retailing, however, there is evidence that new firms frequently rely on price cutting as a means of getting their start; and as they become well established and are more strongly motivated by a desire for security, they forego that aggressive weapon and turn to more conservative tactics. This legislation then falls in the large class of special-interest laws designed to make it easier for those who are already in the charmed circle and harder for those who would like to get in. The effect of devices of this general category upon the supply of enterprise is apparently negative.

It may be objected that the tenor of the foregoing paragraphs envisages such a degree of free competition as to be quite impractical as a realistic goal; and if such a close approximation to perfection is required, we may as well give up hope now for maintaining a free market system. Such a conclusion would be unwarranted, for we have always had, and probably always will have, a mixed system. A free enterprise system can stand a certain amount of this mixture of private monopoly forces and of government aid to them. But we would suggest that we have enough of these forces, probably too much, and that we would be better off with less rather than more.

## CONCLUSION

The problem of maintaining competition in our economic system to a sufficient degree and in such forms as will make it effective as the main regulator of our economy is, it will be seen, one which must be attacked on a number of fronts. The most obvious one, which has been indicated, is an enforcement of the antitrust laws. Another is the lowering or abolition of trade barriers between countries and between the states in our union. Another is the development of a resistance on the part of government to those demands from occupational groups, such as retailers, farmers, workers, and others, for government-sponsored monopolistic conditions. Another is a reform of our federal tax system to make it more favorable to "venture capital" and to new business, and, in general, a continuing policy of government

which will make for ease of entry into business. Finally, there are policies which can be followed (and in many cases are followed) by business organizations, especially in their selection and promotion of men into executive positions, which have the effect of placing the control of those organizations under men who are competitively minded. These different attacks upon the problem would mutually support one another and, in total, we believe, can preserve for us, in the face of powerful counterforces, that degree of workable competition which is necessary as the regulator of a free market system.

In a liberal democratic-capitalistic type of society, one of the most important functions of the organized state is to check the natural propensities of individuals to combine in order to avoid the rigors of competition. But after all, the state in a democratic society represents the will of its people; and the essential requirement, therefore, for the preservation of a competitive society is in certain qualities of the people themselves. In general, it is probably true that a people get the kind of social and economic system which is consistent with their qualities. For a competitive system the qualities of self-reliance and confidence are essential. Only those who have inward strength will be willing to face the contest of free competition, which is the price of economic freedom. The young and the robust in business, as in life generally, go forth "as a strong man to run a race." The tired and the disillusioned crave surcease from the struggle and seek protection even at the cost of a limiting of their economic freedom or even, in some countries, of their civil liberties.

The trends toward group controls and restraints have gone far in some countries with only mild objections or sometimes with the approval and encouragement of businessmen; and these trends have not been absent in the United States. Our N.R.A. in some of its aspects represented a move in that direction. That it did not succeed was regarded by some as an unfortunate evidence of the inability of American businessmen to work together—a conclusion which was amply controverted by the record of production of business firms during the war. But from another point of view, the failure of the N.R.A. was encouraging. One implication was that our Constitution may still save us from some

of our temporary aberrations and failures of courage; but more important for the future of a competitive system was the indication that American businessmen, or at least many of them, even under the stress of our worst depression, were too self-reliant and individualistic to seek refuge in group protection. This and many other day-by-day evidences give a basis for the belief that there are still present among Americans generally and among American enterprisers in particular those personal qualities and attitudes which finally are the real bases of a competitive system.

# 15

## *INNOVATION AND INVENTION*

The distinctive feature of modern times has been change. While this change has characterized all aspects of human affairs, including philosophy, social ideas, and political institutions, there is no aspect in which it has been more marked than in methods of production and distribution of goods and services; and in these fields the changes have represented improvement, at least by the objective tests of costs and output. The purpose of this chapter is to inquire into the nature of this continual change, the policies which will encourage its continuance, and its bearing upon an expanding economy.

### IMPORTANCE AND ROLE OF INNOVATION

From the economic and business point of view, we shall call this process of change "innovation." (Certain distinctions between innovation, invention, and discovery will be noted later.) By innovation we mean the combining of factors of production in new ways and the applying of them to new uses. In a private economy, such as ours, these new methods and new directions of production are typically initiated by business enterprisers.

Indeed, the initiation of new combinations of the factors of production is the major function of the enterpriser. There are, of course, degrees of newness. An enterpriser may bring about a new combination only in the sense that that combination had not existed before at that time and place. For example, a man may decide to establish a grocery store in a new location. He perhaps had previously been an employee in a similar store and merely carries over the ideas and methods which he had learned there. Nevertheless, it can be said that certain workers, capital funds, and a particular piece of land were brought together for the first time.

But a clearer case of a new combination would be one in

which the factors were combined in a different way than had previously been done. Thus, our prospective grocer may have conceived a system by which he could use relatively less labor and more capital and perhaps more or less space in order to accomplish the desired results. He would then actually bring these factors together, hire the labor, borrow the funds, or invest some of his own, and rent or buy the land. It should be noted that putting the conception into actual use represents a second step and that this step is an essential part of the job of the innovator. By thus conceiving and putting into effect this combination, he may have established a new institution of retailing comparable to chain stores or supermarkets, or he may have made a much less spectacular improvement in method or product. Either of these would be a clear case of innovation, and it is to this type of "new" combination, as distinguished from mere duplication of existing units, that we refer when we use the term.

After this combination has been made—or in business terms, after the organization has been set up and put on an operating basis—the remaining job is management. Strictly speaking, this function consists in keeping the wheels turning once the mechanism has been set up. In an unchanging environment this, as some writers imply, may be largely a routine function, but in a dynamic industry it is far from that. Indeed, in such an industry, management, at some levels at least, involves frequent, if not continuous, innovation.

A close relationship exists between private enterprise and progress. Between these the causal relation runs in both directions. First, progress comes largely from the innovation of private enterprisers. The enterpriser in a competitive economy is impelled to strive for improvement, because in such an environment the chief source of profits is in the differential effectiveness with which he can combine and utilize the factors of production, i.e., that part of the land, capital and the labor of the country which he individually employs. Under this stimulus of profits based upon relative effectiveness, there has grown up in this country and in the others of Western civilization a large number of these innovators. As a group they

contribute to progress in a rather disorderly way. There is a continual experimentation, which in our system is based on the assumed rights of men to take foolish chances. There are consequently many failures, but with these many false starts some prove to be sound and fruitful. The competitive market —in the last analysis, the consumers—passes the judgment. This disorder and, by a narrow standard, this "waste," is apparently a necessary feature of progress. Those whose sense of neat order is thereby offended and who would concentrate their efforts on eliminating these wastes should recognize that to do so would no doubt also reduce the accompanying progress. There is no more possibility in human affairs generally than in the scaling of a mountain, that every step should be forward. Only a very naive and inexperienced mountain climber would lay out his course on that assumption. There must be much of the free experimentation of individuals, and we should hope that they will not be restricted to those lines of effort that the group regards as "sound."

The other causal relation is that the need for private enterprise and an important social justification for it is based on the assumption of continued technical progress. Socialist writers and others have recognized that the successful introduction of a thoroughgoing socialist state must await the cessation of what has been called "this perpetual gale." Whether or not one takes that extreme position, it seems clear that the establishment of the grand bureaucracy of the socialist state would be facilitated by a stabilization of industry and correspondingly will be hindered if the economy maintains the dynamic changing qualities that it has shown in the past. In this situation, therefore, the best defense which private enterprisers can make against the possible adoption of socialism is in the encouragement of invention and the ready and daring exploitation of those inventions by themselves. Conversely, when an economy does shift to socialism, it may be evidence that the enterprisers of that country have lost something of their previous dynamic qualities. One is tempted to apply this explanation to the recent movement toward nationalization in some countries. At any rate it does seem clear that the establishment of

cartels and other schemes for stabilizing an industry or the whole economy (thereby avoiding competition) is a common forerunner of the establishment of a system of national socialism. The moral seems clear, that if a free economy is to perpetuate itself, it must retain its dynamic qualities. Thus, the continuance and encouragement of innovation attain importance, not only in their effect upon the standard of living of a country, but also in their influence on its social and political system.

Moreover, as was argued in Chapter 2, there are purely economic grounds for believing that the successful continuance of a private enterprise system depends upon continued innovation. The points made in support of this contention (Chapter 2), were: first, that labor-saving devices would create intolerable underemployment of our resources if new activities were not devised at the same time and at a sufficiently high rate to absorb those unemployed; second, that the propensity to save increasing amounts, if not increasing proportions of income, creates a need for using those savings if unemployment is to be avoided; and third, that there is an annual increase in the labor force which requires new employment opportunities.

It would be an overstatement to say that innovation is always necessary in order to maintain full employment; for it is conceivable that, in a condition of underemployment, the slack could be taken up by producing more of known things even by known methods. But in a condition of full employment, expansion—that is, expansion of output and more effective use of capital—could only take place as a result of innovation. In the one case, therefore, innovation encourages expansion; and in the other, it is essential to it.

Innovations fall in two categories, as suggested by our definition. First, the devising of improved ways of accomplishing old results. Thus, the introduction of many new mechanical processes, the manufacture and use of new productive machines, and new methods of organization of industry and trade—for example, the application of the principle of scientific management to manufacturing and the adoption of the chain method of distribution—are devices for accomplishing more effectively re-

sults which were accomplished before at greater expense. They are all "labor saving" in their immediate effect.

Second, innovation also includes the manufacture of things which were previously unknown. Into this class fall some of the most dramatic advances, such as the manufacture and improvement of the automobile, the radio, and the telephone. It is not clear whether the improvement of methods of producing old things or the introduction of new products has made the greater contribution to economic well-being. A very strong case could be made for the contention that the production of things which did not exist before has contributed even more to the improvement of the lot of the people generally, than have the gains which have been made in the cost of producing previously known goods. The point, incidentally, is of some significance in the attempts to measure statistically the improvement in living standards, for any such measurement must deal only with those things which were in use at an earlier time and at the present. Such an index is too heavily weighted, therefore, with the staple articles, such as lard, wheat, and cotton sheeting, and gives insufficient weight to the utterly new things. If this criticism of statistical measures of changing living standards is valid, it means that the quantitative description greatly understates the degree of improvement which has taken place, for example, since 1900.

The private enterprise or capitalistic system has provided, at least in the past, many elements favorable to the creating and accelerating of the rate of advance of both types. While one cannot say that in the future this dynamism could not be supported by any other system, it does seem in the past to have rested peculiarly upon the initiative of individuals, each of whom was free to experiment and to make his bid for public approval in the market place.

## DISCOVERY, INVENTION, AND INNOVATION

When we think of the changes in productive methods of the last 150 years, our minds turn naturally to the inventors of that period. Invention, however, is only one aspect of industrial

progress; and an even more important one is innovation. To clarify the distinction between these two requires that we add a third concept, namely, discovery. What are the lines of distinction between discovery, invention, and innovation? Discovery refers to the finding, the uncovering of facts and relationships which were previously in existence but unknown; for example, Columbus discovered America, Harvey discovered the circulation of the blood, and Newton discovered certain laws of physics. Invention is the mental creation of a thing which did not exist before. Eli Whitney was the inventor of the cotton gin in the sense that he conceived, drew the plans for, and made a model of that machine. It will be observed that both of these concepts involve purely mental processes and results. The third term, "innovation," differs from these two in that it involves action. After the invention of the cotton gin, someone had to "do something about it." Someone had to provide funds and labor, managerial ability, and resources for the actual production of a real cotton gin.

The mere definition of these terms suggests the close relationship between them and also the division of labor which exists in modern society between those who perform these functions. Discovery is the function of science and particularly of pure or basic science. Inventions frequently, and probably to an increasing degree, depend upon the discoveries of basic science, although the inventor is, of course, not necessarily a scientist and still less is he necessarily capable of putting the invention into use. The innovator, in turn, relies primarily upon the inventor and only indirectly upon the scientist. The distinction between the three is worth noting, for each should recognize the necessity of the functions performed by the others.

The distinction is also worth noting because a country may be more effective in some of these functions than in the other. Thus, the people of the United States have been noted for their Yankee ingenuity, that is, as inventors. We can probably justly claim a greater superiority in that field than we can in the field of basic science. But the United States has been noted even more for its innovators. There are many instances (the automobile industry is one) in which both the basic science and some of

the basic inventions were made abroad but in which the leadership was gained by this country because of the enterprise and daring of businessmen who seized upon these intellectual accomplishments and put them to highly useful employment.

There is probably good reason for this emphasis in the United States upon invention and innovation in the practical attitudes of the people, in the freedom to follow the profit motive, in the strength of that motive in this country, and in the enterprising spirit of our businessmen. These national features have naturally served better to encourage applied research than basic research, for the former obviously has a more direct (although perhaps in the long run no more important) bearing upon profits and economic progress than the basic discoveries. In certain European countries, on the other hand, the impetus to extend the field of knowledge has been more encouraged than has its application, because of the social structure of those countries, the support of research by the government, and a lesser development of business enterprise.

In view of results in the past, we perhaps have nothing to regret in this relative emphasis. For one thing, there was a sort of free trade in ideas and international division of labor which made it possible for us to look to Europe for the great discoveries in basic science and to devote ourselves more especially to the application of those principles. This we have done; most of the laws governing the transformation of energy, the physical and chemical structure of matter, and the behavior of electricity, light, and magnetism have come from Europe. This dependence, it is true, has become much less marked in recent years. We have made notable advances in the field of pure science; but at the same time, our efforts devoted to applied science have increased even more rapidly, so that even today we are still relatively underemphasizing the former.[1]

While this dependence upon other countries for basic research may have occasioned no serious difficulties in the past, we believe that we cannot afford to continue in this position. There are several reasons for this belief. For one thing, the rate of

[1] Cf. Vannevar Bush, *Science, the Endless Frontier, a Report to the President, July, 1945*. (A condensation in a supplement to *Fortune*, September, 1945, p. 5.)

advance in pure science has been tremendously accelerated in recent decades. In earlier days a fruitful discovery might be made, and only decades or a century later would some other investigator pick it up, amplify it, or combine it with other discoveries. Today the large body of active scientists seizes upon such discoveries and pushes on to the next steps in a much shorter period of time. This means that one cannot afford to wait for the knowledge of scientific advance to spread through the whole scientific world, but rather that there is an advantage in scientists working in close contact with one another. It is true that this requirement is partially met by the better means of communication today, especially through scientific journals that have an international circulation and other means. But this facility for interchange of ideas is partially neutralized by deliberate attempts on the part of national governments and other organizations to prevent this quick spread of knowledge. The attempt at drawing curtains around the work of scientists is, of course, deplorable. But such efforts would have been much less serious a century ago because the naturally slow rate of permeation of ideas would have made such efforts less effective and their consequences less serious than today.

Another reason is that the rate of transition from the pure-science stage to the applied-science stage and finally to actual application has been accelerated. Witness, for example, the discovery of penicillin and its quick application, or the discoveries as to the nature of the atom and the development of the atomic bomb. The third reason why we cannot continue to rely upon foreign countries for basic research is that those countries, which were chiefly those of western Europe, have been impoverished and demoralized as a result of the war.

Still another reason is that applied research and invention have come to depend more than before on scientific findings. Primitive men learned to use sails for their boats without any knowledge of why the winds blew. The "know how" of the race has advanced from the earliest known times. The "know why" is largely a product of the past century or two. The greatly enhanced fruitfulness of invention in recent years is partly due, and in some cases entirely due, to the underlying "know why"

which is the business of science. Though the dependence of practical invention on formal science is often exaggerated, there is no question that it is increasing and that this trend will continue.

The upshot of all this is that we could not afford to rely upon national specialization in the world of ideas, even if the related "free trade" in ideas had continued; and the situation is now aggravated by the fact that restrictions have in fact been imposed upon that trade.

## RESEARCH AS A BASIS OF INNOVATION

The technique for the advancement of science is research. Research, in turn, is the orderly, more or less systematic, and intensive search for previously undiscovered truth. Three different kinds of research can be noted. The first is pure research or basic research directed to the discovery of new things or principles. Second, background research which includes the job of establishing precise data—for example, the classification of biological species, the establishment of contour lines in geography, the job of standardizing units of measurement, especially in new fields such as radiology, and so on. This work is highly important, first, for the continuation and advancement of basic research, and second, for the practical application of research. This type of research, at least in the popular view, lacks the glamor and drama of the great discoveries; but its value is illustrated by the problems which confront inventors and scientists when that routine work has not been well done. For example, it has been said that, when Edison was working on the incandescent light,

> his objective was to produce a lamp filament of high resistance and small cross section of good mechanical strength capable of incandescence upon heating by the current flow and to be made of low-cost materials. Platinum filament lamps were known, but the platinum filament for the resistance which he desired would be too fragile and expensive. He sought a suitable substitute in the form of a carbon filament, but nothing was at hand which would yield a filament of the desired coherence and strength. He tried all manner of organic com-

> pounds, paper, fiber, wood. He tried hundreds and hundreds of organic substances and finally found, in a certain type of bamboo which grew on a high plateau in India, a suitable substance which could be formed to shape and charred into a compact filament.
>
> Viewed as a final achievement, this was a great advance in the industry, and gave us modern lighting. [But it was a costly method.]
>
> It involved determining the characteristics of various materials from a single standpoint. If science had gone ahead and tabulated the characteristics of those various substances from all conceivable standpoints, hundreds of inventions might have sprung from that type of inquiry instead of a single invention from an inquiry into hundreds of substances from a single standpoint.[2]

The third type, applied research, includes in industry so-called "industrial research of manufacturers," in medicine the application of known scientific principles to therapy, and in national defense the application of basic principles to military ends (the atomic bomb, for example).

An important distinction between these three types of research is the support which they are likely to get from private business enterprises. Basic research is only remotely related to private profits; and, moreover, there are the obstacles in the form of practical difficulties and the traditions of science to making basic discoveries the exclusive property of the discoverer. Hence, this type of research makes a relatively weak appeal to the profit motive, especially to the hope for early profits. Support of basic research by private business has not been entirely lacking, however. Some large organizations, notably the laboratories of the Bell Telephone System, the General Electric Company, and others, are doing important work in scientific research that is not specifically directed to their own or to other practical problems. This is commendable; but, after all, business organizations exist for specific purposes, and they cannot be expected to devote a large part of their energies to the pursuit of knowledge for its own sake even though they recognize that such knowl-

[2] John A. Dienner, *Chemical and Engineering News*, February 3, 1947, p. 304.

edge may have utility some time to somebody. Here is a field of endeavor, then, which even in a dominantly private economy must have support from the nonbusiness agencies. These agencies are chiefly the universities, the endowed foundations, and the government. Since the universities are in a position to conduct the research but must rely upon others for financial support, this burden falls to the latter two and chiefly to the government.

The need of increased support for scientific research, particularly for basic or pure research, is indicated by some recent trends in research expenditures. While the total amount expended for research has been increasing (in the United States it more than doubled between 1930 and 1940), the increase during the thirties was almost entirely in the field of applied research. It is estimated that industry before the war spent about 15 per cent of its research total or $7½ million to pure research. Colleges, universities, and endowed institutes spent 70 per cent of their research budget, or a total sum of nearly $23 million, in this way. Total national expenditure for pure research thus amounted to approximately $40 million; while that for applied research reached a figure of $227 million, a ratio of about 1 to 5.6. In England, where the development of industrial research is admittedly very retarded, the corresponding ratio of pure to applied research is estimated at 1 to 1.2.[3]

Dr. Vannevar Bush makes the following observations:

> In the decade from 1930 to 1940 applied research was expanding much more rapidly in the U.S. than was pure research. During this period industrial research expanded by 100 per cent and governmental research by 200 per cent. Research in colleges and universities increased by 50 per cent, and the endowed research institutes (which were primarily devoted to pure research) declined by nearly 15 per cent. It may be concluded, therefore, that since governmental and industrial expenditure is growing so rapidly, relative to that of the universities, generous support to university research is essential if the proportion of pure to applied research is to be maintained at anything like the previous relationship.[4]

[3] Bush, *op. cit.*, p. 7

[4] *Ibid.*

A very important problem facing a country which places chief reliance for the direction of its affairs upon private initiative is to enlist the support of the government and quasi-public bodies without at the same time placing control in the hands of those bodies. It is essential that the latter result should be avoided, for although modern research requires financial support in very large amounts, there is no activity in which the freedom of the individual investigator is more important. It is this paradox that constitutes the problem. We have developed in the United States in our large universities a *modus vivendi* by which these seemingly opposed requirements are reconciled. The state or the private donor supports the activities, but the institutions and the individuals within them are left in substantial freedom as to their lines of inquiry. It would seem, therefore, that a promising policy would be for the federal government, acting perhaps through a national research council, to provide and allocate funds to men and institutions which are regarded by the members of such a council as best equipped and able to use them fruitfully. While some progress has been made in organizing research projects and in planning their direction in advance, it still remains true that one cannot predict results; and it is, therefore, impossible to hold men or institutions responsible for the attainment of those results as one might do, for example, in manufacturing or construction. This peculiar feature of scientific research requires that the government shall follow a liberal policy as to methods and final results, and this policy presents difficulties in a democratic system which is accustomed (and properly so) to holding recipients of public funds to strict accountability.

The difficulties, great as they are, must be met and overcome; for here, it is believed, is one of the basic responsibilities of government in its broadest sense which deserves to rate beside the maintenance of law and order, national defense, education, establishment and regulation of the coinage, and other fundamental functions of the state.

Likewise, the so-called "background research" calls for concerted action, and the federal government has assumed considerable responsibility in this field—witness the activities of such

institutions as the Coast and Geodetic Survey, the Bureau of Standards, the Naval Observatory, the Department of Agriculture, and the Geological Survey. Co-operative associations of technical men are also engaged in this field—for example, the Society of Automotive Engineers in standardizing automotive parts, and the various testing associations which establish standards for units of strength and quality of materials. In general, the performance of this function seems well cared for and at least poses no new fundamental problems.

As to applied research, the largest volume will presumably continue to be done by private industrial concerns. Very great progress has been made in expenditures on industrial research. They increased from $116,000,000 in 1930 to $240,000,000 in 1940.[5] The expenditures during the war by industry, as well as by the government, were still further increased. Nevertheless, in view of the importance of the function and of corresponding amounts spent on other activities by business, these sums seem very moderate. However, now that industry has been convinced of the importance of systematic research in the development of its products and the discovery of new methods of production, the road seems clear to expand those activities, at least as far as the large organizations are concerned. This qualification, however, suggests another aspect of the problem, namely, that here is an activity in which large business enterprises have an advantage over small ones. This problem, on which some comments were made in Chapter 10, is a difficult one. It cannot be solved by government conducted or sponsored research, because the attractiveness of a new device or new product from the point of view of a small enterprise often requires a degree of exclusive control if funds are to be invested in its commercial development.

## NONSCIENTIFIC KNOWLEDGE

The remarkable results of systematic laboratory research in recent decades have caught the imagination of people to such an extent that there is a danger of losing perspective. Statements are often made to the effect that all progress and worth-while

[5] *Ibid.*

knowledge are the result of research. This is clearly a gross exaggeration. The body of knowledge which the human race possesses is to a much greater degree the result of commonplace observation and trial and error. This probably would be true even in many so-called scientific fields and is more clearly true in the workaday life of the people. The patents which are registered in the patent office give evidence of the continued fruitfulness of individuals' efforts to solve their own special problems. For example, in all the years that screws have been used, there has been the problem of the screwdriver easily slipping out of the straight slot that is prepared for it. It surely required no laboratory research nor the conscious application of newly discovered principles for someone to hit upon the idea that cross slots in the screwhead, together with a screwdriver made to fit them, would overcome that problem. So it is with millions of other advances made by an ingenious people.

The philosophic and practical significance of this observation is that, if it were true that we live primarily by the knowledge of science, then the scientists (that is, the experts) would be in a better position to direct everyday affairs than the uninformed individuals. The implication of such a doctrine for types of social organization are apparent. In spite of the growth of organized science and the great organizations which apply that science so brilliantly, the fundamental strength of the American people seems still to rest upon the fact that there are in the United States some three and a half million business enterprises outside of agriculture and about six million business enterprises in agriculture. This means that we rely for innovation upon nearly ten million independent units, in every one of which experiments may be tried and where no higher authority is needed to authorize the experiment.

### EXPLOITATION OF DISCOVERIES AND INVENTIONS

Moreover, in view of the spectacular progress of science and the fruitfulness of invention, it is perhaps not surprising that some writers seem to imply that invention and innovation are the same thing or, at least, that if we have the inventions, we need not worry about the application of them. Dr. Vannevar

Bush is so impressed by the importance of basic research that in his very significant report on our scientific resources, previously mentioned, he implies that the businessmen of the country can be depended upon to make use of the fruits of this research and presumably to sponsor the applied research which is necessary as the intermediate step. It is true that, as our economy is organized, we must rely upon business enterprisers and investors for putting scientific ideas into effect; but it is dangerous and unjustified to take it for granted that that step will always follow. Certainly there have been many countries noted for their scientific eminence in which the necessary role of the entrepreneur has not been forthcoming. For example, some of the most important work in the development of the wireless telegraph, which in turn formed the basis of radio communication, was done by Marconi, an Italian. But Italy, the birthplace of the basic idea, was not adapted to its development. The development was done by other countries, notably the United States, in which business enterprise was more highly developed and better rewarded.

Also, it is clear that in this country there have been periods, such as the decade of the thirties, in which scientific progress did not languish or in which the number of practical inventions did not decline but in which, nevertheless, the production of new things and the adoption of new methods was at a low level. Research and the application of its results are different things; but they are mutually dependent, and the cause of neither is advanced by deprecating or by taking for granted the presence of the other.

The mutual relationship can be viewed also in the opposite way, namely, that research, and particularly applied research, is very definitely stimulated by the spirit of enterprise and innovation and that the activities of the applied researchers and their needs provide the basis for public support in the form of necessary funds for pure research. The American people as taxpayers have been surprisingly liberal, particularly in the case of state universities, in supplying funds for activities which to most of them were quite incomprehensible. They have been willing to do so because they have become convinced that progress in the fields of health and industry and other practical

fields does depend, in some mysterious way, upon this pure research. The advocates and practitioners of pure research should not delude themselves into thinking that the suppliers of funds share their enthusiasm for knowledge for its own sake. As previous paragraphs should have suggested, this comment is not to call in question the value of that pure research but is simply to say that its advocates should recognize, as a matter of reality, its relation with and indeed, its dependence upon the mundane "practical" results.

Not only does scientific research depend upon invention and commercial innovation for popular support in the sense of a favorable attitude of the public, but pure research on the scale which it has now attained, and even more which it should attain, requires large funds and a high national income. These must be produced by an effective economy. And the responsibility for the requisite level of productivity in our country rests, in no small measure, upon the business enterprisers and particularly upon those who put the fruits of research and invention to productive use.

The main problem, therefore, is a unified one, and its solution depends largely upon maintaining an innovating, experimental attitude on the part of all our people. There are a number of ways in which public policy can affect that attitude or, at least, its expression. There is, for example, the patent system, about which more will be said later, and tax reform. In this latter field, the treatment of losses for income tax purposes can have a pronounced effect upon the willingness to experiment; experimentation always involves risk of loss, as well as prospect of profit, and if the effect of these losses can be cushioned by allowing them to be deducted from other sources of income for tax purposes, innovation would obviously be encouraged. Some improvement of our tax system in this respect has already been made, but there is still room for greater improvement. It should be observed that inevitably the government, in levying taxes upon business income, as indeed upon any kind of income, is in the position of a "fair weather partner," for it is hardly feasible in a private economy that the Government should share in losses as it does in profits. The suggested line of reform is, therefore, necessarily only a partial one.

Another possible line of tax reform designed to encourage innovation is to reduce business taxes, particularly in the early years of the life of an enterprise. A very large amount of the funds utilized for expansion comes from the earnings of the enterprise itself, and this is particularly true of new concerns whether large or small. If, therefore, we wish to encourage this innovation and expansion, we should leave as large an amount of these early earnings as possible for this purpose. Still another way in which the tax system could be modified to encourage innovation would be, merely by administrative regulation, to allow a greater freedom in the rate of depreciation on plant and equipment for tax purposes; for those directing a new enterprise may well desire, for good business reasons, to write off their investment as early as possible.

These are merely examples from the single but important field of tax policy which suggest that the encouragement of a spirit of innovation is coming to be more and more a matter of wise public policy, and that its continuance in this country is no more to be taken for granted than man's impulse to search for truth.

## INNOVATION AND COMPETITION

The spirit of enterprise and the consequent propensity to change is not entirely a matter of economic forces. It rests as much upon the desires of individuals to make new things and to try new methods and upon the existence of a social system which permits the flowering of this tendency as well as upon purely monetary rewards. That is one reason why it is impossible to make sweeping generalizations as to the bearing of the number of enterprisers and the degree of competition between them upon the rate of innovation. For example, it is sometimes said that a high degree of competition will foster innovation and that an approach to monopoly would discourage it. But we have before us the example of the American Telephone and Telegraph Company, which has established a most notable record of expansion and improvement in the services which it renders and in the cost of rendering them. But this industry is not particularly marked by competition, at least of the direct kind. It is true that, in a broad view of the matter,

the telephone is in competition with the telegraph, the postal system, and other devices of communication; but these forms of competition are sufficiently removed as to make it impossible to explain the existence of the Bell Telephone Laboratories and the constant alertness which appears to have characterized the industry merely on the basis of competitive necessity. On the other hand, the Post Office also has a monopoly to about the same degree; and in the last forty years, it has made no such record of improved service or cost reduction. It is easy enough to say, as many do, that the effect of bureaucracy in business can be as deadly as in government; but the Post Office, our most notable example of government monopoly, hardly supports that view. One seems justified in concluding that the profit motive and the considerably greater freedom of individuals, within the privately owned concern, to advance their own interests by progressive attitudes toward their work have much value for maintaining dynamic qualities.

Nevertheless, and despite some notable exceptions, such as the one just given, it is probably true that a substantial degree of rivalry between concerns bidding for consumer support is conducive to such progress. This view is supported by an observation of such fields as the automobile industry, the electrical appliance trades, and others; and it is, moreover, a result which one should logically expect. One enterprise which is the sole representative of an industry, that is, a monopoly, may, because of the dynamic quality of its leaders, be progressive; but, in the absence of those qualities it does not need to be so. But in an industry characterized by keen rivalry, profits are made chiefly by one company getting away from the standard and generally accepted methods of production, locating in a new place—for example, the cotton mills moving into the South—or producing improved products or entirely different ones. The reason, of course, is that prices become adjusted close to cost levels when all companies are producing substantially the same things in the same way. Profits to a company must then come from reducing costs (a form of innovation) or producing a new or better product. Moreover, when the leader has become established, he is in a position to attract a larger part of the market

either by reduced price or by the superiority of his product. The other companies, which may not have been characterized by the spirit of innovation at all, are forced, as a matter of survival, to follow suit. Thus, under competition, progress does not need to await a general advance but can be made as a result of the progress of even one dynamic concern. The prospect of finding one such concern among the several in an industry is better than the prospect that one concern occupying a monopoly position would be so characterized.

Nor is this driving force of competition merely explained in terms of the search for profits. Rather, an industry in which there are several rivals will be impelled, in much the same way, by the spirit of adventure and by the desire for prestige, which lead some to seek the leading place and impel others to follow.

Closely related to the effect of competition upon innovation is the relative propensity of individuals or small groups to adopt new and untried ideas, compared to the corresponding propensity of large groups and particularly the state. There appears to be good reason for expecting a greater propensity to innovation among those of the first category. The fact is that most people never will depart from the beaten path; but we can confidently expect that, among a very large number of such individuals, some of them will do so if they are free to conduct their affairs in their own way. If, on the other hand, these individuals have to get the approval of a large group or of the representatives of the whole society, the decision is likely to be a conservative one. For example, in the early days of the automobile industry, innovation was surely encouraged by the fact that a few daring and imaginative souls could go ahead without getting the consent of others. If it had been necessary for Henry Ford or the other pioneers to persuade the whole society, as represented by a responsible government, it is very doubtful if that consent would have been given.

Nor is this peculiarly a characteristic of government; it is reported that certain promoters in the automobile industry in the early days sought financial aid from a certain large banking house in New York for the purchase of the young Ford Motor Company at a very moderate price. The story goes that this

aid was refused because the new industry was probably only a "flash in the pan." If there is truth in the report, it does not necessarily mean that the individual members of the board who collectively made such an erroneous judgement were completely lacking in imagination and foresight; it may mean simply that they appreciated the risks which were very real and that, when acting for a large group and in a trustee position, they did not feel justified in risking other people's money. As individuals, the same men might have been willing to take the chance. Banker control of corporations has become almost synonomous with conservatism. But the same men, when handling their own funds, are frequently as prone to taking risk as are other investors.

It may well be argued, therefore, that large groups, and particularly a socialist state if it is operated by men who are responsible to the people, would characteristically follow a policy of "not sticking your neck out." In passing, it may be noted that this line of reasoning would not apply to a dictator who felt himself to be in such a strong position that he did not have to account for his decisions to his people. This suggests, then, that a high level of innovation may be expected from a free system in which the daring individuals can take the lead, or possibly in a totalitarian state, but that conservatism is likely to rule in the midway position where power is unified but where those who wield it are responsible to the whole body of citizens.

## MONOPOLISTIC COMPETITION AND INNOVATION

It will be observed that we have been using the term "competition" in the general and not too precise sense of rivalry, that is, in the businessman's sense. In the precise terminology of economic theory, perfect competition implies perfect mobility of the factors of production and perfect knowledge on the part of enterprisers and investors of opportunities for the employment of their efforts and capital. It is sometimes argued by some, who too readily draw practical conclusions for public policy from the pure theory of economics, that perfect competition is the ideal toward which a competitive society should

strive. As far as economic progress is concerned, this conclusion can well be questioned.

If the conditions of perfect competition were generally realized, there would be little basis for progress. Suppose, for example, that these assumed conditions actually existed in an industry and, therefore, that all of the enterprises were using the same methods and that the rate of return had become fairly uniform and presumably had settled at a low level. Now if an invention was made or a new method of production conceived by someone perhaps outside the enterprise group, what would be the incentive for one of these enterprisers to adopt it? If he does invest his funds and effort, there is always a possibility of failure; and if instead the new idea is successful, the competitors in this "perfect" situation would *immediately* adopt the new process. Thus, immediately the conditions of perfect competition would again reinstate themselves, and the sought-after profit would not materialize.

It might, of course, be argued that the newly discovered cost-reducing method would be adopted, in spite of this fact, merely on the ground that with lower costs and lower prices large volume would follow which would make possible more business, although at the old and moderate rate. This, however, places heavy reliance upon the anticipation of a highly elastic demand; and, in any event, the argument stakes its hope of progress upon a motivation which would appeal to a monopolist as well as to a competitor. It seems, therefore, that new investment of time and capital designed to reduce cost or to produce better things can only be attractive to an enterpriser if he can anticipate some period of time in which he will enjoy a differential advantage over others in the trade. This means that in the strict use of the terms of economic theory a position of monopoly or quasi-monopoly extending over a longer or shorter period is essential to progress and that a condition of perfect competition would not be conducive to that result. On the other hand, perfect competition would serve well to keep prices close to costs and to enforce efficiency in the use of the best method of production *which was actually in existence*. The attractiveness, therefore, of "perfect" competition is to be

found in that imaginary static state in which, by definition, the introduction of new products and changes in the arts are not to be expected.

A temporary differential advantage is provided by a patent monopoly in which the government assures the user of the new product that for seventeen years he will not have to face the competition of others using the same device or method. Even where the law-created monopoly does not exist, a time lag usually exists between the introduction of the new method by one firm and its adoption by others. This lag may arise from research by the first firm, the results of which are kept secret from competitors; or it may arise from the time that is required to solve the problems of actual production, even when the basic principle is understood; or it may still further be induced by the time required to raise new capital and by the hesitancy of competing firms to plunge into the new and unproven venture. This latter point suggests how firms which are directed by bold and daring enterprisers may maintain a lead (in the event that their guesses are right) over their more cautious competitors.

This effort to maintain a lead is, of course very widespread in American business. This is illustrated by efforts to supplant even newly introduced products. One leading chemical company is devoting part of its energies to the efficient production of penicillin, but its research efforts are devoted not to the improvement of that product but to the discovery of some other thing which will be even better. If the hypothetical conditions of perfect competition existed, all their efforts would be devoted to maintaining the established level of efficiency for production of the old product. In this case, and generally, we can anticipate that progress will come from seeking a new product or improvement in an old product that will *not* be directly competitive. But, of course, this company is not the only one which is in the race. We thus have a *competitive striving to avoid direct competition.*

What becomes, then, of the proposition that competition is an aid to expansion? Apparently the statement only holds if we refer to that degree of competition which will prevail in an economy that is characterized by the normal frictions which

represent a considerable modification of the ideal of perfect mobility and perfect knowledge. Some writers have pointed to this fact with the implication that, if (as we move from perfect competition over to the quasi-monopoly conditions described) we encourage progress, then by an extension of the reasoning we can conclude that a perfect monopoly represented by the socialist state would give still more encouragement to progress. This extreme conclusion does not follow; when competition is completely absent, a number of the incentives for progress mentioned above would be removed. Hence, the conclusion seems to be that progress will be impossible or at least discouraged by a close approach to either of the two extremes—perfect competition or perfect monopoly—and that the most fruitful situation for the encouragement of progress is to be found in the midway position between those two.

This conclusion, reached on theoretical grounds, is borne out by the observation of actual business. It seems true that the greatest progress in methods of production, in improved products, and in the introduction of new products has been made in the United States in recent decades by such industries as the automobile industry, the electrical appliance industry, the chemical industry, and others in which the conditions are clearly not those of perfect competition as conceived by economists; nor are they closely connected to the conditions of monopoly. These industries are characterized by conditions in which a limited number of producers compete for the consumer's dollar but in which the products are somewhat differentiated and, moreover, in which research and developmental work is carried on by the individual companies, with the fruits of those activities being made first available to the companies who have made them.

The interrelations of competition and of temporary or quasi-monopoly can be put in another way. The existence of keen competition tends to reduce the earnings of all companies to a low and dead level. The desire to escape from this situation leads to efforts to reduce costs of production or to produce new or improved products. The possibility of escaping from this type of competition is provided by frictions such as the delays of

competitors in setting up new plant or in acquiring the needed "know how" or by legal obstacles to the perfect mobility of capital and enterprise. In other words, the unattractiveness of a purely competitive situation combined with the possibility of tempering it by product differentiation or by cost reduction provides the spur to progress.

Another relationship is noted, namely, when the advance has been made by one company, the force of the competition between that company and the other companies impels the other companies to adopt the methods or products introduced by the innovator. The more enterprises in the industry that adopt the improved methods, the greater the pressure becomes upon the remaining ones to do likewise. Putting these two relationships together, we then have this situation: first, conditions approximating pure competition at any point of time provide the incentive for individual firms to break away from that competitive level; second, the frictions and obstacles to an immediate following by the others provide the possibility of a company doing so; third, when the innovation has been introduced by one firm, then the force of competition makes it essential for the other firms to adopt the improvement; and fourth, if these firms do adopt it, competition forces a price close to cost, and we are back at our starting point with a strong incentive for individual firms to break out of that "dead level." Thus with these interrelations of competitive conditions and the limitations upon pure competition, we have a mechanism which powerfully works to bring about improvements and to force the general adoption of those improvements by the whole producing community.

## PATENT SYSTEM AS ENCOURAGEMENT TO INNOVATION

From what has been said, it seems clear that in a highly competitive society there is an obstacle to innovation in the readiness with which some firms can take advantage of the successful innovations of the more enterprising firms without bearing the same risk of failure. A partial way of overcoming this obstacle is provided by the patent system; for a patent

insures its holder the right to exclude others from the use of his patented idea for a specified period of time (in the United States, seventeen years). Two points should be noted here. In the first place, the necessity for a patent system grows out of the fact that the economy is generally competitive. If that were not true and if, instead, the inventing individual or company could, by control of resources or other monopolistic devices, prevent others from following in his train, then there would be no need for a patent.

A second point to note is that the patent granted by the government does not, as is often stated, give the possessor thereof the right to produce and sell the product; the inventor has that right without any recourse to the patent system. Nor is it entirely true that the patent creates the right to exclude others from its use, for in some cases the inventor could do so without the patent system merely by keeping the process secret. What the patent does do, then, is to set up a sort of bargain which the public, represented by the state, makes with the holder of the invention, whereby he agrees to make full and complete disclosure of his new method or product and in return receives the aid of the state in excluding others from its use for a limited period of time.

It can, therefore, be justly argued that the patent does not deprive the public of any rights which it had before. Before the invention was made and disclosed, the public had the right to use the older known methods. The making of the invention and the disclosing of it gives to the public an *additional* right, and the patent merely places limitations upon that additional right. These observations concerning the nature of patent rights appear to be appropriate because there is a substantial trend of thinking in this country in late years which seems to proceed on the assumption that a patent creates a monopoly and that it is, therefore, suspect and (as some imply) a kind of fraud upon the public. Or, as some would say, the body of knowledge as to processes and things is a part of the public domain, that is, open to use by anyone. A patent, in this view, represents an area carved out of this public domain. The opposite view, and the one accepted here, is that the new idea was not a part of the

public domain at all until it was conceived *and disclosed.* The exclusive right to its use, therefore, only places a restriction on what the public has thereby gained.

The concept of the patent as a grant of the legal right to exclude exists in the law of all civilized countries with the exception of Russia, where instead bounties are paid to inventors.[6] Historically, the patent is sometimes traced to the royal monopolies granted by the monarch in England frequently to personal favorites or to others for services rendered. Actually, the origin of the patent system might better be said to have been in the law of 1623 in England which prohibited such royally created patents but made the specific exception of those granted to inventors, thus establishing the modern patent system in statute law in this backhanded way. When our government was formed, it was provided in the Constitution that "the Congress shall have power to promote the progress of science and useful arts by securing to authors and inventors for limited times the exclusive rights to their respective writings and discoveries." In the act of 1790 and by amendments up to 1836, our patent law was established in the form which, with some minor changes, is still in effect. The law provides:

> Any person who has invented or discovered any new and useful art, machine, manufacture or composition of matter, or any new and useful improvements thereof, not known or used by others in this country before his invention or discovery thereof, and not patented or described in any printed publication in this or any foreign country before his invention or discovery thereof or more than two years[7] prior to his application, and not in public use or on sale in this country for more than two years prior to his application, unless the same is proved to have been abandoned, may, upon payment of the fees required by law, and other due proceeding had, obtain a patent therefor.
>
> Every patent shall contain a short title or description of the invention or discovery, correctly indicating its nature and design, and a grant to the patentee, his heirs or assigns, for the

[6] Temporary National Economic Committee, *Hearings* (Superintendent of Public Documents, 1940), testimony of Lawrence Langer, 1939, p. 1008.

[7] In present law, one year.

> term of seventeen years, of the exclusive right to make, use, and vend the invention or discovery throughout the United States and the Territories thereof, referring to the specification for the particulars thereof. A copy of the specification and drawings shall be annexed to the patent and be a part thereof.[8]

By constitutional provision and by the statutes based upon it, our new government recognized and committed itself to two propositions: first, a recognition and assumption of responsibility by the state for the encouragement of science and the arts; and second, a particular method of accomplishing that result. There are other conceivable methods. Indeed, some of these methods were considered by those drafting the Constitution. It was suggested, for example, and supported by such an eminent statesman as Alexander Hamilton, that the desired results should be accomplished by the payment of rewards for such discoveries. It now seems clear that any such method would have been fraught with great difficulties and faced the danger of arbitrary favoritism and attempts at directing the activities of the people by bureaucrats. Under any such system it would, of course, be necessary for someone to determine whether a discovery was practically useful and, indeed, how useful. When we consider the low opinion that was entertained by contemporaries of many of the inventions which have later proven to be very valuable, the weakness of this plan becomes apparent. On the other hand, if one could disregard these very practical objections, there would have been one advantage in such a plan in that it would have been possible to reward discoveries in fundamental science; the present system is of actual commercial advantage only in the case of those discoveries and inventions which lead directly to saleable products.

For these reasons it seems that the same device cannot be used as a *direct* aid to invention and commercial development on the one side and to scientific discovery on the other. For a long time that gap in our incentive system was serious and perhaps partly explains the fact that the progress of basic science in the United States in the nineteenth century failed to keep pace with

[8] From the Act of 1836.

advances in invention and the use of practical things and methods. Today that weakness is partly but not entirely overcome by a growing recognition of the dependence of applied research and invention upon basic research; and hence some concerns in a number of industries, are including in their research activities basic as well as applied research. In small companies which cannot afford to support such expensive research themselves, there is a growing recognition of the need for such basic research in the universities and other public and quasi-public institutions. The primary utility of the patent system, however, is the encouragement of invention and commercial exploitation, and the chief economic aid to basic research must continue to be in monetary contributions in one form or another.

From the point of view of the industrial progress of a country, it should be emphasized again that the commercial exploitation of the idea is fully as important as the conception itself. Indeed, in some ways this latter step of assembling or otherwise providing the capital, employing the workers, promoting the knowledge of the product with consumers, setting up the marketing machinery for distributing the product, and so on, requires some of the same originality necessary for making the discovery or invention. In addition this exploitation requires, to an even larger extent, decisions, action and the assumption of risk for the sake of prospective reward. In view of the basic incentives that motivate people, it is probably true that the economic advantage provided by the patent is even more important and more necessary as a stimulus to this commercial exploitation than it is to the invention itself. There are those who believe that the instinct of contrivance would be sufficient to bring forth much of the effort of inventors.[9] But it is clear, as these observers point out, that no such non-economic incentive would be adequate to induce investors to stake their funds in the development of the idea.

This contrast can, or course, be easily exaggerated; for especially in these days of industrial laboratories, the very act of invention also requires the investment of funds. But enough of

[9] Notably F. W. Taussig. See, for example, his *Inventors and Money Makers* (New York: Macmillan Co., 1930).

truth remains to indicate that the patent system is of even greater importance in making possible the use of the ideas than it is in bringing them forth. To the extent that this is true, then, a system for encouraging innovation must primarily yield economic advantages, not only (or perhaps not mainly) to the inventors but to the innovators who make use of the inventions. This point needs emphasis because of the rather widespread view that somehow the patent system has failed if it does not yield its largest rewards to the inventors themselves. It must be remembered that the primary purpose of the patent system is economic innovation which will reduce costs of existing goods and make new goods available to the public. It is only along that line that the standard of living and the economic power of the country is advanced; and, from that economic point of view, the "progress of science and useful arts" in the limited sense of discovery and invention is only the preliminary step.

In summary, then, it appears that the patent system, viewed in its broad outlines, seems well designed for the encouragement of innovation and progress in a free market economy. It takes from the public nothing which the public had before; it provides an incentive both for invention and for commercial exploitation of the inventions; and it automatically adjusts the amount of that reward to the value which the market, i.e. the public, places upon it. But while this seems to be a justified verdict as to the basic nature of the system, there are, as in any man-made system, weaknesses and room for reform. To the criticisms and proposed reforms, we now turn our attention.

## PROPOSED REFORMS IN THE PATENT SYSTEM

The American patent system is regarded as one of the most extensive and liberal in the sense of granting rights to the patentee. It is believed that in the past this liberality has been very effective in encouraging inventions and the use of those inventions, thus contributing importantly to the rapid technological and industrial growth of this country. Our system has been copied in many other countries of the world, and some of the

more liberal provisions particularly have been incorporated into the systems, not only of the newer industrial countries, but of some of the older ones. It is, however, a very complicated system, not so much because of the law itself but because of the many uses of patent rights which have evolved in our complicated economic system. Much of this is unavoidable; and it has been pointed out by the Commissioner of Patents that, in general, the more highly developed the industrial economy of countries is, the more complicated the patent system has become. It would probably be a mistake, therefore, in our country to strive for such a simplified legal system as might be feasible in a country of less elaborate industrial relationships.

One consequence of this fact is that the practice of patent law has become a specialized field to which able men devote their whole attention, and a large and highly refined body of patent law has developed. It is, therefore, very difficult for the nonspecialists to make positive recommendations for change. This is not to say that our law should be made only by lawyers but rather that reforms which may seem very simple and needful to the layman often have ramifications which will not be apparent to him and which may well lead to quite unexpected and undesired results. For that reason, as well as the limitations of the present study, positive recommendations will not be made here. We may, however, profitably note some of the issues that have been raised and some of the major arguments concerning them.

The alleged weaknesses are numerous and can be classified in many ways. It may be helpful to think of them as falling into two major classifications: first, those features that hamper the patentee (whether he is the inventor or the enterpriser who has taken over the patent) in securing, using, and defending his patent; and second, those features to which objections are raised on the ground that they unduly restrict the rights of others. By implication, reforms in the former category would tend to strengthen the patent and protect the position of the one seeking a patent or holding it, while the reforms in the other category would look to protection of the rights of others by more

strictly delimiting the monopoly power that is granted by the government.

In the first category, it is contended that the road to the securing of a patent is fraught with many difficulties and annoying and expensive delays. One of these is the practice of interferences. This practice is a natural outgrowth of our basic patent law, which undertakes to give the right of exclusive use to the one who first discovers and discloses a new idea of a method or product. When, therefore, an individual seeks from the patent office the issuance of a patent, it follows that others who may claim to have discovered the idea earlier should have the opportunity of substantiating their claims. For that reason when an application is made for a patent which, in the opinion of the commissioner, would interfere with any pending application or existing patent, the commissioner must give notice to the interested parties and proceed to determine the question of priority. It obviously becomes a difficult problem to determine whether the two ideas for which patents are sought are essentially the same and at what time the two discoveries were made, relative to each other. Successive appeals may be made regarding the decision to higher levels of authority. The determination of these points may well require considerable time and expense. The consequence may be that the inventor is put to such expense and discouragement that he will either drop the effort to secure the patent or make a settlement with those having conflicting claims. Under such settlement, he may either transfer his rights completely, or, in return for a withdrawal of the interfering application, he may agree to grant a license on more or less favorable terms to the interfering persons. A problem does exist here, and the situation may well invite established companies to make applications based on flimsy grounds in the hope of getting an "interference" declared and negotiating a favorable settlement. On the other hand, it is difficult to see how the alleged evil can be removed without impairing the principle that the patent should belong to the discoverer or his assigns. Of course, a solution which would violate that principle is the one used in England and some other countries under which the

patent is granted to the first applicant rather than to the first discoverer or user.

This principle, however, has its own difficulties; first, it is contrary to our basic concept that men gain property rights, not by an arbitrary action of the government, but by the fact of creation, and the function of the government is merely to recognize this fact and defend this right. A second and more practical weakness is that it imposes upon the inventor the necessity of secrecy throughout the period of the development of his idea. If the idea in its earlier stage is secured by another, that person may advance it to the stage of making application for a patent and thus deprive the originator of his rights to it. Another practical corollary is that ideas will be hastened to the patent office when they are still in a "half-baked" stage and with rather vague sketches of the proposed process or thing. Patent lawyers assert that the specifications and disclosure made by American applicants are superior in detail to those made in countries following the other plan.

On the other hand, under that scheme a somewhat similar obstacle can be imposed in the form of an opposition. An opposition differs from an interference in that it can be filed by anyone, whereas the interference is filed by another applicant.[10] The latter gives rise to a contest between two parties as to who really owns the invention, whereas the former is merely a contention that the patent should not be granted to the applicant. The action may perhaps be initiated by a person who is using a method or hopes to use it and who is trying to demonstrate that the thing is not new but merely involves the combining of previously known ideas and, therefore, should not be patented at all.

There seems to be no escape from the dilemma that, if an exclusive right is to be granted, other interested parties must be given the right to protest against this grant of exclusive power and that such protests are bound to constitute a hindrance to the easy securing of a patent. The problem, however, is a real

[10] A somewhat similar action can be taken here by a person who is not an applicant, but it is not common. A more feasible device is to file an application and to get an interference declared. T.N.E.C., *Hearings*, Part 2, p. 718, testimony of George H. Willits *et al.*

one and has the consequences of enabling entrenched companies to defend their positions and of leading to costly and annoying litigation, even between inventors themselves. It is possible that procedural reforms might give some relief.[11]

Another difficulty confronting the holder of a patent in this country is that he never can be completely sure that the patent is valid. This one also arises out of the basic principle that the patent should belong to the one who first discovered the thing and disclosed or used it. Therefore, in a sense, the books are never completely closed, and the granting of the patent is not final. Someone may at any time arise and claim priority of discovery, and if his claim can be established, the patent is invalidated. An attempt to remedy this weakness completely is open to the same objections as the attempts at reform in the problem of excessive interferences. For if the granting of a patent itself is to be finally decisive, the incentive to secrecy during the developmental period may well hamper the process of improvement and may encourage the hasty filing of the application. Some countries have striven to meet this problem by requesting a preliminary application and, after a few months, permitting the completed application to be filed. But this leads to the further complication that the final application may be held not to correspond sufficiently to the preliminary one, and thus it does not completely solve the problem.

In the second general category of alleged weaknesses are certain features and practices which are thought to give the holder of the patent undue power over competitors and potential competitors. The corresponding proposed reforms would tend to restrict and delimit more sharply the patentee's power. First to be noted among these practices is the extension of the effective period of exclusive control by protracting the period of application. It is complained that a prospective patentee can file a number of applications and keep them pending in the patent office year after year by adding minor amendments.[12]

---

[11] These are too detailed to be discussed here. Proposed changes in the law and its administration were offered in the T.N.E.C. *Hearings*, Part 2, pp. 725–35, and in the final report.

[12] E.g., *ibid.*, pp. 714–35.

Since his application is on file, any other person seeking a patent on the same idea would encounter an interference; and, although the applicant does not have power to exclude others until the patent is actually granted, he may observe that in fact no others are employing the idea. When ultimately his patent is granted, it will run for seventeen years from that date; but the termination date so set may well be substantially more than seventeen years after the discovery, or the first use or the application. It is asserted that the patent on the automobile clutch was held up for sixteen years before the patent period started to run; certain motion picture patents (the Fritts patents) were pending in the patent office for thirty-six years; and three dominating patents (Gubelmann patents) in the calculating machine industry were pending for twenty-six, twenty-two, and twenty years.[13] A proposed reform is to extend the patent period from seventeen to twenty years but to provide that the twenty years shall run from the filing of the application rather than from the granting thereof. This proposed reform appears to have considerable support, although there are those who believe that the problem is not sufficiently serious to warrant a change.

Another criticism in this category is the nonuse of the patent. The belief that it is a common practice for companies to buy patents and simply put them "on the shelf" to prevent others from using them is old and widely held. Many competent people have testified that they have never known a genuine case of the kind described. As far back as 1912, Thomas Edison testified to this effect,[14] and Dr. Vannevar Bush has more recently testified to the same effect.[15] A questionnaire, circulated to the American Chemical Society requesting information on cases of this kind, did not yield a single instance.[16] Nevertheless, the popular idea persists, and it was expressed by President Franklin Roosevelt in the message to Congress which led to the creation of the Temporary National Economic Committee and in which

[13] *Ibid.*

[14] George E. Folk, *Patents and Industrial Progress* (New York: Harper & Bros., 1942), p. 258.

[15] T.N.E.C., *Hearings*, p. 908.

[16] *Ibid.*, testimony of George Baekeland, p. 1103.

he recommended "amendment to the patent laws to prevent their use to suppress inventions."

The reasons for this disparity between popular views and expert testimony probably lie in the vagueness of the charge itself. The term "nonuse of the patent" is itself vague and misleading. The patent is not the thing or the process but the right to exclude others from the use thereof. Therefore, the patent in the correct sense is used whenever and to the extent that the holder thereof asserts his right to prevent others from using the idea or the thing. The thought that is usually intended, when the term is thus loosely used, would be more accurately expressed as the nonuse of the process or thing to which the patent applies.

Certainly it is true that not all patented things or processes are exploited, and it is also natural that every inventor should feel that his own invention deserves to be used. It is quite common for a company engaged in a particular field to purchase a large number of patents that give some promise of being useful to it. (Inventors are paid for their patents in any event.) Of the patents so secured, it is quite probable that only a limited number will, upon further inspection and testing, prove commercially or mechanically feasible. Even if the patented thing is found to be practical, before it is put into use, another and better one may appear which would lead to the shelving of the first. Then it is possible that the new device represents a rather minor improvement over the one in use and, in that event, the owner may hesitate to scrap his older equipment. A similar consideration may apply to the products in the hands of consumers which would, by the adoption of every improvement, be so frequently made obsolete as to create consumer ill-will and, taking everything into account, be a disservice to the consumers. The line between these considerations and the outright withholding of a patent from use for the sake of maintaining an entrenched position is so vague that it is not surprising that the conflicting views mentioned have persisted.

In considering this question, it should be borne in mind that the very intent of the patent law is to create the right to exclude

others. There is no requirement in the law that the patented idea be used. The bargain that society has made with the inventor is that if he will disclose to the public something which it did not have before, he will receive in return the right to exclude others from its use for a limited period. In most cases this right will be used to enable the patentee to get a better-than-competitive price, but it can also be used to gain other advantages of exclusion, such as to prevent undesirable hastening of obsolescence. Thus, again the problem seems to arise from the very nature of the patent; and the attitude which people take toward it is apparently influenced by their views of property rights in general and by the strength of their convictions that the government-created right to exclude is the best way in our system, all things considered, for encouraging invention and the useful arts.

One of the proposed reforms aimed at this alleged evil of nonuse is compulsory licensing. Under this proposal, once a patent has been issued, any person should have the right to use it upon the payment of a reasonable royalty. This is a more radical proposal than it may first appear to be; for a patent right is a type of property, and an essential feature of a property right is the right to exclude. For example, if one owns a piece of land that ownership would be impaired almost beyond recognition if it were provided that any other person could utilize part of the land upon payment of a reasonable rent.

There appears to be some question whether such a law could be sustained in view of the provision in the Constitution which grants to Congress "the power to promote the progress of science and the useful arts by securing to authors and inventors the *exclusive rights* to their writings and discoveries." In the absence of that provision, Congress would have no power to enact patent laws at all and the only power conferred is to grant *exclusive* rights. A compulsory licensing system denies the exclusive rights, and thus it may be argued that the making of a patent without that feature goes beyond the powers of Congress.

It is alleged by those who support a plan of this kind that the inventor could be adequately rewarded and motivated by the prospect of such royalties as are determined to be fair; and some

believe that, if an invention could be used by anyone, the inventor would have a better prospect of receiving continued royalties, which might well be in excess of the amount which the purchaser of the patent pays under the present plan. The justice of this argument is difficult to determine for it depends so much upon the rate which is determined by some authority as reasonable and also upon the extent to which individual patents would be used by anyone if they were open to all. But, in any event, this argument applies to only half of the problem because, as we have mentioned before, the right to exclude from the use of the patent is perhaps of greater social utility in providing an incentive to businessmen and investors to utilize the invention than it is to the inventor. Under either the present plan or the proposed plan, the inventor might receive his reward. But the assurance that the enterpriser needs—namely, that he will have a limited period in which he is protected from the full rigors of competition—would quite evidently be destroyed. When the enterpriser undertook to produce the product upon the payment of a reasonable fee, all the competitors, of course, could do the same. Many businessmen (notably Mr. P. T. Farnsworth speaking about the television industry) assert flatly that such weakening of the system, from the enterprisers' point of view, would mean that many new ideas would not be exploited at all. This observation emphasizes again that the problem of encouraging innovation is one involving not merely the inventor, but also the investors and enterprisers.

A further difficulty with such a proposal lies in the word "reasonable." Fairness is an essential element in such a scheme, for the privilege of using the patent would be meaningless if the patentee could impose prohibitive royalties. Obviously, if the government is to enforce such a law, the determination of a reasonable rate would have to be left to some agency of government; and such action would represent an extreme delegation of authority, not only over the property rights of patentees, but also over the detailed questions of who should produce what, and thus over the whole economy.

To meet some of these objections a number of variations in the proposal of compulsory licensing have been suggested. One

is that it should only be required in the event that the holder has for some specified number of years not "worked" his patent. If he does use it himself in this way, he could still retain the right to exclude. This, of course, raises the question of how much he must employ it to retain exclusive control. Also, some inventors object on the ground that they wish to protect their ideas during the time which is required to develop them. Another proposal is that if the patentee voluntarily grants a license to one person, he must make it available to all on the same terms. But here again "the same terms" is difficult to define, for the terms may have been the reciprocal right to use the patents of the licensee and others may have no such patents.

However, while we see many serious and perhaps decisive objections to the proposed plans, the subject should not be left without emphasizing that the problem posed is not imaginary. The central thesis of this book is that we need an ever expanding economy, and it follows that to attain that economy we must have a high level of innovation. While it is true, as we pointed out, that there are a number of perfectly natural reasons for the nonworking of a patented idea, the fact is that that result does exist, not in the crude form to which the charge commonly refers, but for reasons which in themselves may be perfectly legitimate. This does not mean, however, that someone else might not find it profitable to employ the patented process or make the patented thing. A concern which has considerable investment committed to the production of one thing or to the use of one method is in quite a different position from a new concern which desires to break into an established market. In a number of industries and situations within our private enterprise system, it is to these newcomers that we must look for innovations. The fact that one company can refrain from "working" a patent and yet prevent others from doing so is, in a sense and to a degree, inconsistent with the general philosophy of a freely expanding economy.

The objection that we have been considering is nonuse of patented things and methods. Allied to this question is the alleged use of the patent to strengthen, extend, or create a monopoly power or a restraint of trade. There are many aspects of this

alleged evil. One of these, which may illustrate the general problem, is the use of the patent pool. By this device a number of established companies may make their patents available to one another. In some industries these patents may run into thousands, and it would be very difficult for anyone to engage in the industry without infringing on some of these patents. The power to exclude new enterprises becomes apparent. On the other hand, the patent pools may be used for quite different purposes; for example, in the automobile industry, if any one company could only use the patents which it itself controlled, the progress of the industry would have been greatly retarded. This was early recognized and a scheme was established by which, with few exceptions, the patents in that industry were made available for use by any manufacturer, whether long established or new in the field.

We cannot hope to give even a description, much less an appraisal, of the interrelations which grow out of the use of licenses. It is believed by some that the real difficulty arises in the improper use of patents and that the anti-trust laws are adequate to prevent such improper use. A patent is a property right, and under it the owner can do certain things, as he can with any other kind of property; but like other kinds of property, a patent does not give him the right to enter into combinations or conspiracies with others which would have the effect of restraining trade. Those holding this view point out that any property right whatsoever is a monopoly in the limited sense that it gives to the owner the right to exclude others from the use of the thing owned. In that sense a manufacturer has a monopoly in the ownership of his plant which includes the right to exclude others from using it. But under our anti-trust laws this property right does not empower him to make agreements with competitors as to how that property shall be employed. In like manner, it is argued, the same limitations apply to the patent.

Under the present law, as interpreted by a long line of decisions, the owner of the patent may assign that right to another. Moreover, he may make a limited assignment. Thus, he might say that he will license another to manufacture under his patent for sale within the state of Michigan or in any other

geographical area. He may specify the maximum amount which the assignee may produce under the license or the assignment. Furthermore (and this touches a tender spot), he may specify the price at which the assignee may sell the product (General Electric case). He may do all these and other things, providing the assignment is not made or used in such a way as to violate the anti-trust laws which prohibit combinations and conspiracies in restraint of trade and attempts to monopolize.

For example, the owner of a patent apparently would be stepping over the line if he not only prescribed the price at which the licensee may sell the product but also attempted to require him to fix resale prices. The point is that the law (in the absence of certain statutory exceptions) looks with disfavor upon agreements aimed at the control of resale prices, and the possession of a patent does not in any way extend the individual's privileges in that respect. Likewise, the anti-trust laws can be applied to cases where the patent pool is used under agreements designed to restrict competition.

In this view, then, the problems of cartels, exclusive patent pools, and crosslicensing arrangements can best be met by the application of anti-trust laws and, if need be, by their overhauling and extension. This would seem to be a more promising line of attack than an attempt to weaken the property right which the patent system specifically gives. In other words, if it is necessary to limit property rights for the preservation of competition, that should be done to such rights in general and not to this one in particular.

## SUMMARY

We can summarize the observations which we have made concerning research in its various forms and commercial exploitation by saying that we have four levels of activity, all of which must be carried forward. They are: basic research, background research, applied research, and exploitation. These are the four horses which, if working together, constitute a powerful team for economic progress. The successful co-ordination of their efforts requires the combined energies of certain very different groups of people who too frequently in the past have

not appreciated one another's values. These groups include the pure scientists who may desire nothing more than to be allowed to search for the basic principles which underlie our physical universe. They include the routine scientific workers who meticulously classify plants, animals, and minerals and who reduce their physical characteristics to quantitative terms. They include the practical inventors and industrial researchers who have little concern with basic principles as such but who are intensely interested in the sheer engineering efficiency of methods and the effectiveness of products.

They also include enterprisers who see the possibilities of utilizing discoveries and inventions, in the first instance for their own profit or other satisfactions and in the final analysis for human use. Among these four groups, a high degree of respect and recognition of mutual dependence should exist.

The four functions will, in a free society, be supported and carried forward by different agencies. The responsibility for financial support of the first, basic research, must rest largely with government (state or national) and with private donors, with private business playing an important but, in our opinion, a secondary role. The second, background research, can apparently be supported most appropriately by government, working through universities and its own agencies, and in a secondary way by trade associations, and, because of the nature of the problem, only in a minor way by individual business firms. The third, support of applied research, is rapidly being expanded by private business; and we can reasonably expect most of its support to come from that source, with the actual work being done either by the business organizations themselves or by universities and private laboratories with the financial support of business. The fourth, exploitation, is a matter very largely for private business, at least in this country, and the normal business incentives are especially important to achieve it.

One of the greatest problems for a democratic-capitalist society to work out is a satisfactory balancing of these responsibilities and activities. In our opinion, here is as good an illustration as will be found of the fact that wise social and public policy is not to be found in laissez faire, which is a mere mini-

mizing of government; and certainly it is not to be found in a general expansion of government power in the guise of economic planning or under other names. These extremes are bad because they are not discriminating. We need a political and economic philosophy that will recognize the fields which can best be left to the natural and spontaneous energies of individuals on the one side and to the support of groups represented by the state or quasi-public bodies, such as universities, foundations, and trade associations on the other. In the progress that has been made on some aspects of this problem of scientific and industrial progress, there is ground for optimism that this general problem of maintaining a dynamic economy can be solved by democratic processes.

# 16

## *TAXES*

THE question of taxes and incentives can be regarded either from the point of view of using taxes as a positive incentive for stimulating enterprise or from the point of view of minimizing a deterrent to enterprise. The former approach forms the basis for so-called "incentive taxation." There may be some ways in which the levying of taxes can be used to stimulate action, but a fundamental objection to that approach exists on the ground that it is a device for penalizing persons for not doing the things we want done. In the general theory of motivation, this approach is regarded as less effective than the one which provides positive reasons for doing the things desired. Moreover, it is more consistent with the philosophy of freedom to provide rewards which the subject is free to accept or reject rather than to apply penalties.

However, once a tax or a tax system has become established, the relaxation of the burden of taxes may be regarded as a reward; and a manipulation of rewards in this sense may be utilized to direct activities into desired channels. Tax allowances or deductions can be used in that way. If a tax system bears upon business activity in general, a specific exemption in favor of producing a particular thing or in favor of doing business in a particular way, such as through co-operative associations, might well bring results. But when one is dealing with such a general matter as the supply of enterprise for a country and the encouragement of risk taking and venture, which is the object of our concern, it seems more sound to proceed on the assumption that taxes on business enterprise in general have a deterring effect, by reducing either the rewards of enterprise or the funds available for expansion, and that such taxes should, therefore, be generally reduced rather than manipulated in a detailed way to special ends.

In a still more inclusive view of the bases of economic progress in a free market system, we can conclude that taxes are generally bad. That is one of the reasons why discussions of specific tax matters are always somewhat unsatisfactory, for unless the aggregate of taxes is reduced, the wisest possible choice will only mean that we have found the least of several evils. From the point of view of strengthening incentives to expansion, the first effort should be to reduce the total amount of necessary taxes; and this means to reduce the total expenses of government, which is, at the same time, the most difficult and the most important of tax reforms.

## AGGREGATE BURDEN OF TAXES

That the reduction of the total tax burden would be the greatest encouragement to enterprise will be apparent if we recall that government activities always constitute competition with private business, either in the very direct sense or in the sense of competition for the consumer's dollar. The dollar that is paid in taxes cannot be used to buy the products of private enterprise nor can it be used for private capital formation. In general, then, the higher the aggregate of taxes, the less freedom individuals have to direct their own expenditures and investments. Fundamentally this means that high taxes, no matter how wisely distributed, are inimical to a private enterprise system. Consistent with this line of reasoning is the fact that some people believe that attempts to adjust the tax burden upon the members of the community in one way or another is largely futile and that the only genuine tax reform is one which reduces the total tax burden. But in qualification of this view the analogy of a man carrying a pack upon his back seems justified. It is true that the pack constitutes a handicap to his progress and that, other things being equal, the heavier the pack the greater the handicap. But, at the same time, it is perfectly clear that a pack which is well arranged and skillfully adjusted can be carried more readily than one which is badly adjusted. In the tax problem too, the remedies are not only to reduce the weight but also better to adjust the burden.

It should further be added that, while the most important

feature of taxes may be the aggregate amount of them, that amount should be viewed in proportion to the tax-paying capacity of the community. A grown man, for example, can carry without trouble a pack which would be unreasonably burdensome to a boy. There is no one simple measure of this capacity, but the amount of the national income would be at least one indication of the tax-paying ability of a country. Judged even by this standard, the burden of taxes in the United States has greatly increased in the past few decades. For example, it is

TABLE 7

FEDERAL TAXES AS A PERCENTAGE OF NATIONAL INCOME*

| Year | Per Cent | Year | Per Cent |
|---|---|---|---|
| 1913 | 1.9 | 1934 | 6.3 |
| | | 1935 | 6.8 |
| 1922 | 6.4 | | |
| 1923 | 4.7 | 1936 | 6.4 |
| 1924 | 4.6 | 1937 | 7.0 |
| 1925 | 4.1 | 1938 | 8.0 |
| | | 1939 | 7.1 |
| 1926 | 4.3 | 1940 | 6.6 |
| 1927 | 4.4 | | |
| 1928 | 4.1 | 1941 | 7.9 |
| 1929 | 4.1 | 1942 | 11.2 |
| 1930 | 4.6 | 1943 | 15.5 |
| | | 1944 | 26.0 |
| 1931 | 4.4 | 1945 | 25.5 |
| 1932 | 3.8 | | |
| 1933 | 4.4 | 1946 | 22.6 |
| | | 1947 | 19.3 |

* Source: *Facts and Figures on Government Finance, 1946–47* (New York: The Tax Foundation, 1948), p. 48.

estimated that in 1913 all tax collections (federal, state, and local) comprised about 6 per cent of the national income, whereas in 1946 that proportion had reached 28 per cent. It will be recalled, of course, that the national income has greatly increased during this period, from $35 billion in 1913 to $162 billion in 1947, and that the increasing percentages represented a much greater increase in the amount of taxes. The total tax collection (federal, state, and local) in 1946 was over twenty times as large as it was in 1913, and about four and one-half times as large as in 1930. The increase in federal taxes alone during that period was even more pronounced, rising from about 2 per cent of national income in 1913 to nearly 23 per cent in

1946, and over 19 per cent in 1947. The growth of federal taxes as a proportion of the national income by years during this period is shown in Table 7.

## ABILITY TO PAY AND INCENTIVES FOR ENTERPRISE

It is now commonly accepted doctrine that taxes should be levied in proportion to ability to pay. In that respect, our attitude toward taxes is different from our attitude on prices. We do not ask people to pay more or less for their shoes or for their housing, depending upon their financial status, although there are some exceptional areas, such as the professional fees of doctors, in which that principle is applied. There are like exceptions in the field of taxation in which we attempt to impose taxes in proportion to specific benefits derived from government. But, by and large, a wide difference exists in the levying of charges upon individuals by private sellers and by the tax-collecting agency. No one, of course, would seriously question the propriety of the general principle of taxing in proportion to ability to pay. It should be noted, however, that once this principle is accepted, we have embarked upon a line which has no discoverable logical end short of equalizing all incomes. For if one individual is receiving $5,000 and another, in similar circumstances, is receiving $4,000 and it is necessary to raise $1,000 from the two of them, it can plausibly be argued that the whole sum should be taken from the $5,000 income. To stop at any point short of that would mean that the less affluent individual would be taxed more than in proportion to his *ability* to pay. But this represents a confusion between *minimizing* the total burden (which this proposal does) and *equalizing* the burden between individuals, which is what most people have in mind when they talk about ability to pay. The fact is that the very concept of ability to pay any amount less than one's whole income is extremely vague and subjective.

To translate the term as "equality of sacrifice" is a little better, for at least that gives us the conceptual ideal of so setting the tax that the amount taken will result in an equal sacrifice *occasioned by the tax*. Such a concept supports a progressive tax[1]

[1] Taxes in their relation to the income of the taxpayer are classified as proportional, progressive, or regressive. The first applies a uniform rate to all incomes; the second ap-

but not a tax that goes all the way to equality of income. (The principle in this form is still, of course, subject to the difficulty of evaluating sacrifices, which are purely individual and subjective matters.) It is subject to the further objection that it runs counter to the requirements of incentives. For if two people at different income levels are considering the question of assuming disutilities (work, risk, and so on) and we assume the reward to be the same, the more needy person may assume these disutilities even if the reward is reduced 80 per cent, while the more affluent person might balk if the reward is reduced 20 per cent. Thus, the ideal of leaving sufficient incentive for action by both individuals would call for a regressive tax, the opposite of that which would be required by the ability or sacrifice ideal.

If one desires to induce additional effort over and above that which an individual is already exerting, it would seem that the reward for that effort should be at a higher rate than for the effort which he previously put forth. This principle is recognized in wages in the form of higher rates for overtime. In the case of the progressive tax, we are following precisely an opposite principle. While this opposite principle may be required by equity, it is clearly not consistent with the incentive requirement. Since both of these requirements are valid in a free enterprise system, some workable compromise is obviously needed.

It is probable that the incentive requirement and the equity requirement can be compromised at this point, but it is not likely that they can be reconciled. In other words, we may decide that we will go so far toward the ideal of ability to pay, even at the expense of reducing incentives; and we may somehow hit upon a practical stopping point. But it is still true that the closer we come to satisfying one of these ideals, the farther we depart from meeting the requirements of the other. In that sense, the most that can be hoped for is a reasonable compromise and not a reconciliation of objectives.

---

plies higher rates to larger incomes; the third applies lower rates to higher incomes. The regressive feature of taxes generally is more or less concealed. A tax of a uniform amount, such as a poll tax, is regressive because it represents a smaller proportion of large incomes than of small ones. Also, a general sales tax is regarded as regressive, for the uniform rate applies to that part of income spent for the taxed goods; and it is believed that, as incomes advance, smaller proportions of them are used in that way. Special taxes on high-priced luxuries may be progressive in their effect.

In applying the principle of progressivity and, at the same time, doing the least necessary violence to individual incentives, it is important that we determine whether the effects of tax rates applying to different income levels form a continuous series or whether there are significant breaking points. If we assume that progressively higher rates, applied as we go up the scale of incomes, do have a depressing effect upon enterprise and risk-taking, then are there any particular points which mark an important change in that effect? For example, it has been suggested by Alfred P. Sloan, Jr. and others that a tax of 50 per cent of marginal income does constitute such a point. In other words, when an individual can retain at least half of the additional income which he may acquire from a venture, he may be willing to undertake it. But if more than half is demanded of him, he will probably decline the opportunity. It is possible that some such psychological bars do exist, and a study of that question would seem to be appropriate as a part of the incentives approach to the problem of taxation.

From the point of view of incentives, the marginal tax rates are more important than the average tax rate under our progressive system of taxation. This fact gains significance because the personal income tax is computed in terms of additional blocks of income. For example, under the law (at the moment of writing), a person with $50,000 of income and certain assumed deductions and exemptions pays about $24,000 in income taxes. His average rate is thus 48 per cent. But because of the progressive principle expressed in the surtax brackets, if he earns an additional $1,000 income, his tax on that increase would be $684, leaving him only $316 net out of the $1,000. His marginal rate is somewhat over 68 per cent. As one moves into higher incomes, the proportion of *additional* income going to taxes continues to increase. Since most decisions involving greater effort or the assumption of risks are induced by the *additional* income, it is clear that the marginal rate is the more significant one. This marginal rate has increased very substantially. For example, twenty years ago, a married man with two children and having a net income of $20,000 would have paid about 8 per cent of any $1,000 increase in his earnings, while

today he pays over 50 per cent of that extra $1,000.[2] At this point he may well feel that he has become a minority partner in his own additional income. The incentive effects are obvious, for many economic decisions involve the balancing of additional income on the one side, against the attractiveness of greater safety of assets, greater security in employment, or less effort and more leisure on the other side. A highly progressive tax undoubtedly, in many cases, swings the balance in favor of the more conservative decision. In this, as in so many economic matters, the practical questions are those of "more or less." Many people are never confronted with the questions of working or not working, of saving or not saving, of taking risks or not taking them. The real questions are whether to work *more or less*, to save *more or less*, or to assume risks *more or less*. Here is where tax policy and other public policies can have decisive effects. As one writer has put it, our economic and social policies on these practical questions have in recent years, with unfortunate consistency, favored "the little less." One group of tax students has expressed the significance of marginal rates as follows:[3]

> In a modern integrated economy the welfare of each of us depends upon the use made of the productive capacity of all of us. If marginal tax rates on coal miners were so high that they preferred to work only three days a week, we would all be much worse off. If the taxes paid by most farmers were so high that they preferred to sit on the front porch rather than strive for maximum production, all of us, not merely the farmers, would suffer.
>
> Just so, we all lose if business managers and investors face tax rates so high that the urge to economic expansion with its attendant risks is weakened. We can expect that most people will do their regular jobs as well as they can. But economic progress and the opening-up of new and more productive jobs require doing things that are extraordinary and risky. Powerful motives are needed to encourage men to change from a secure position to one with chances of brilliant success or total

[2] Illustrative data in this paragraph from the Research and Policy Committee of the Committee for Economic Development, *Taxes and the Budget* (New York: 1947), p. 47.

[3] *Ibid.*, p. 48.

failure, or to induce an investor to risk his funds in the development of new products, processes or services. Very high marginal tax rates reduce the force of these motives.

This is not the place for a description of the present federal tax system, but the relative use of the major taxes should be noted. The main source of revenue is the individual income tax, which at the present time is paid by some 50 million persons. This tax applies on incomes in excess of certain personal exemptions and deductions. The rates are progressive and range from 19 per cent on the first $2,000 in excess of the exemptions and deductions (not on the whole income), to about 86 per cent on income in excess of $200,000. The next most important tax from the point of view of revenue yield is the corporate profits tax, which is at the standard rate of 38 per cent and which applies to all corporations that earn $50,000 or more in a year. Corporations with smaller profits pay somewhat lower rates. Another important item is excise taxes, that is, taxes on the sale of specifically named goods and services, such as alcoholic beverages, tobacco, and gasoline. These three types of taxes constitute the major revenue producers. Among the others are employment taxes (social security), estate and gift taxes, and customs duties. Approximate amounts are indicated by the estimated cash receipts from the public in the year ending June, 1948, as follows:

| | *Billions* | *Per Cent* |
|---|---|---|
| Individual income tax | $20.5 | 46 |
| Corporate profits tax | 8.5 | 19 |
| Excise taxes | 7.2 | 16 |
| All others, including sales of war surplus materials | 8.5 | 19 |
| Total | $44.7 | 100 |

## TAXES ON THE BUSINESS ENTERPRISE

At a number of points, we have seen that businessmen tend to identify themselves with their enterprise; and, to the extent that they do so, a tax burden placed upon the enterprise itself might have a more serious deterring effect than a tax of equal amount which rested upon them as individual income receivers

or consumers. The business tax has a more direct effect upon the decisions of the businessman than a tax upon his personal income, partly because his concern with the success and stability of his business involves more than the income which he hopes to get from it. Moreover, the funds used by business in this country, particularly those employed by manufacturing and merchandising businesses, come largely from the earnings of the enterprise itself rather than from outside investors. While this is a common source of funds for businesses of all sizes and ages, it is particularly relied upon by small, growing enterprises. Since the income of the enterprise is such an important source of its growth capital, the tax on the business concern has an adverse effect not only from the point of view of incentives but also from the point of view of providing the necessary "sinews of war."

It would seem desirable that business decisions should be made as much as possible in the light of costs, prices, and market conditions if we are to gain the advantage of a self-adjusting free economy. The ideal tax, then, would be one which was neutral, that is to say, one which obtained funds with the minimum of influence upon the decisions to produce them. The farther the tax can be removed from the business activity itself and from the day-by-day decisions which businessmen must take, the closer would we approximate that ideal of noninterference. In that respect, a tax levied upon personal income receivers as such, without any discrimination on the ground of source of income, would seem preferable to the tax levied upon the business organization.

There is a further question of the propriety of levying a tax upon the income of the enterprise *in addition* to a tax upon the personal incomes of businessmen. If an individual is so situated that his marginal rate for the personal income tax is 50 per cent, then an added $1,000 of income from salary, fees, rents, or bonds is taxed at that rate. So also it is if the income is from dividends—which is, of course, reasonable. But in this latter case, a tax of 38 per cent has already been levied upon the income as part of the corporation's earnings. For example, if the individual's pro rata share of the earnings of the corpora-

tion in which he holds an ownership interest is \$1,000, there is a tax upon it of \$380. The remainder, if paid to him as a dividend, is \$620, and to this his personal rate of 50 per cent applies. This reduces the original \$1,000 to \$310, and thus the effective tax on *this* part of his income is \$690 or 69 per cent. This duplication of taxes and the tax burden on the income from enterprise constitutes a discrimination against that form of income. In that sense, it has been widely criticized and condemned by students of taxation of all hues of political and social opinion. There seems to be no justification for this double burden placed upon a particular form of income from the point of view of equity and certainly not from the point of view of incentives. The effect of such a tax is to discourage attempts to secure income by employing people and resources and to create a tax incentive for investing funds in government debt of one kind or another and in favor of wage and salary income rather than income in the form of profits; in other words, the effect is to create an incentive in favor of deriving income from holding jobs instead of from making them. This tax also provides an incentive to the business concern to employ borrowed capital instead of equity capital, for the interest on the former is a deductible expense while dividends are not. It is clearly undesirable to create a tax bias against this particular method of financing.

It should be noted further that this special burden of taxation rests upon income derived from the corporate form of business only and, thus, has the further objection that unintentionally the tax system provides a bias against a special form of business organization which has been found very useful. This discrimination between forms of business is not important with large businesses, for they are almost universally organized as corporations; but it is of importance to small business in which the partnership or individual proprietorship is feasible. In this area, such a tax discriminates against those who would like to use the corporate form. From the records, since the time the corporation income tax became a substantial item, it is not possible to draw final conclusions as to the effect which this tax has had upon the form of business enterprises. That it has

tended to encourage a trend from corporations to partnerships is suggested, however, by the fact that, of active corporations and partnerships on which reports are available, the partnerships were 38 per cent of the total in 1939; in 1940 they were 44 per cent; in 1941, 49 per cent; and in 1942, 52 per cent.[4]

The corporation income tax bears most heavily upon those concerns which, from the point of view of preserving effective competition and the dynamic qualities of our economy, we ought to encourage. These are the relatively small concerns that show promise of growth. The very small company at the moment of birth typically gets its capital, as we have shown, on personal grounds, while the large established firms can (theoretically at least) get funds from the general capital market on an impersonal basis. The small-to-medium size firm must rely largely upon retained earnings for its growth capital. To meet this objection some tax students have suggested a more extensive use of the progressive principle, with reduced rates on relatively small concerns. Some of the motives inspiring this proposal are laudable, but in my judgment it is a poor solution for several reasons. There is the difficulty of defining such companies by an objective test—what is small in one industry is large in another. Moreover, the problem of securing equity capital from "the market" is in these days very difficult even for large firms. And a more general objection is that if a tax is bad in principle, we should not try to make it more palatable politically by easing the impact merely upon those whose power of effective protest is greatest. The only real solution if we want to encourage an expanding economy under free enterprise is to get rid of (or substantially reduce) any tax that especially bears upon venture capital, that is, upon equities.

The difficulties of getting rid of a tax, against which such serious criticisms are leveled lie partly in the problem of finding an acceptable alternative source of income and partly in the treatment of the troublesome question of undistributed profits. As to the former, a consideration of business incentives and of equity points to the merits of an undiscriminating tax upon

[4] Tax Institute, *How Should Corporations Be Taxed?* (New York, 1947), p. 63.

personal incomes regardless of their source. Such a solution is supported by the apparent desirability of removing the tax as far as possible from the making of business decisions. There are those who would go still farther and provide special tax exemptions or reductions for dividends and other incomes of enterprise. From an incentive point of view, much can be said for these suggestions; but, of course, they encounter objections regarding equity and the further objections to subsidies in general.

The other difficulty—the problem of undistributed profits—is largely a matter of equity. If a corporation earns an income which it does not distribute to its owners and if the corporation itself were not taxed, it may be argued with some justice that an escape from taxation has been provided for the shareholder. To eliminate the tax on the enterprise and still meet the problem of such undistributed profits, three main suggestions have been made. First, it is suggested that the shareholder include in his taxable income his proportional share of any income which the corporation has made, whether distributed or not. In effect, this would be treating corporate income as we do partnership income. Second, it is suggested that the corporation continue to pay its tax, whether distributed or not, but that the shareholder be given credit in computing his tax for what the corporation has paid on his behalf. In so far as earnings are distributed, this would resemble the withholding tax on wages and salaries with which taxpayers are now familiar. In so far as earnings are not distributed, it would act as a simple undistributed profit tax. This is essentially the British plan. The third suggestion is that we should not try to tax undistributed profits because they really are not income to the individual until they are distributed. The argument is that we could well say to owners of business that, as long as income is put back into the business and thus used for productive purposes, it will not be subjected to tax levies at all. Of course, as such reinvested funds yield their anticipated fruits in enhanced earnings and as those earnings are distributed to individuals, the earnings would be taxed to those individuals as part of their personal income. Moreover, when any individual sells his equity

to another, he will have a realized income to be taxed as capital gains, either at the rate of other income or at some special rate. Also, equity and the desire to avoid concentration of wealth would call for a tax settlement at the death of the original owner. A consideration of the merits of these three alternative approaches to the problem will not be undertaken here. Each has its supporters among competent tax students who agree in condemning the corporation tax, at least at its present levels, and who disagree only on the alternatives.

The problem is not beyond solution. The essentail requirement is for us to recognize that our greatest need for a growing economy is to provide funds for capital expansion. Naturally, if one starts with the assumption that the essential requirement is to increase consumption, a basis is provided for such an undistributed profits tax as existed in 1936–37. Then the hope seemed to be that by forcing business organizations to turn their earnings back to individual owners, the owners might spend a larger proportion of their earnings than the business would have spent. But what those relative proportions would be is not known. Moreover, it seems that what is spent by the corporation is more likely to go for capital goods and, thus, to have a greater multiplying effect on employment than dollars spent for many consumption goods. In view of those uncertainties, it would seem best to leave the use of such funds to the discretion of enterprisers and owners, with the minimum of influence from the tax laws.

## AVERAGING PROFITS AND LOSSES

The levying of taxes on the income of the business enterprise gives rise to a number of questions of definition. We should, of course, be concerned with net income, and that means that the income from one part of the business must be consolidated with income or losses from other parts of the business. This requirement, which is obviously supported on grounds of equity, does nevertheless give an advantage to multiline companies. Quite aside from tax considerations, these multiline companies are in a more favorable position for entering upon a new project than the single-line companies, for if the multiline concerns do suffer

a loss on the new project, that loss can be set against the profits of the rest of the line, and with a corporation income tax the net loss from a failure of the new project is reduced. The newly established concern is usually engaged in the production of one thing or one narrow line. This hazard of "all the eggs in one basket" is thus added to the natural hazards of business infancy and both are aggravated by the corporation tax.

But there is another problem of determining income, and that is in the setting of the appropriate tax period. It is necessary to be arbitrary in this matter, for the conduct of business is not broken into neat periods of a year or any specific number of years. But the longer the period that is considered, the less serious this problem becomes. The problem of extending the period, which is desirable from the point of view of reducing risk, and of still conforming to the Treasury's requirement of annual tax collections can be met by the device of carry-forward and carry-backward of losses. The use of this device in present tax laws represents, from the point of view of incentives for expansion, an improvement over a rigid tax accounting period; and in general, the longer the period thus envisaged, the better from both this point of view and that of equity.

In the starting of a new business, one must commonly expect losses during the promotional and developmental period. An enterpriser or investor may be willing to face that prospect if the possible rewards in later years are high. If, however, the high profits before taxes are to be radically reduced by taxes, the attractiveness of that compensation for the new concern is correspondingly reduced. This difficulty is partly overcome if one can set the losses which he has incurred in earlier years against the later profits, and that is accomplished by the device mentioned.

It should be noted, however, that the averaging of earnings is only a partial remedy; for the possibility that faces the newly established concern is that it may have only losses. To overcome that prospect, there must be the other *possibility* that the profits may be rather handsome. If whatever profits are made are reduced by business taxes, obviously the necessary balancing of profit prospect against loss prospect is impaired. The only way that result could be avoided and for taxes still to be levied on the

business concern would be for the government to agree that it will reimburse the enterpriser for his losses in equal proportion to the share which it will claim in his profits if he makes them. In a free enterprise system, it is clearly out of the question for the government to do that; therefore, the problem will always be with us. It can be minimized by the devices mentioned or by moving the tax back to the personal income of an enterpriser instead of levying it upon the business enterprise itself. When the government levies taxes upon income, business or personal, it is "declaring itself in," as a fair weather partner, in the sense that it claims a share of earnings, if made, but does not stand ready to bear a share of the losses if incurred. This, as was said, is inevitable; but its effect can be reduced by the averaging of profits and losses over a period of time.

## TAXES ON CAPITAL GAINS

There are two ways by which an individual may receive income from a business enterprise in which he has an ownership interest. He may receive the income currently as it is earned and distributed by the enterprise, or he may leave the income with the business unit over a period of years and finally sell his ownership interest at a value which presumably was enhanced by these accumulations. Since these are merely two ways of receiving the same income, it would seem that, if one is taxable, the other should be taxable too. Under our present system, they both are taxable, but in different ways and at different rates. In the case of income currently received, it is taxed as a part of and at the rate applicable to the general income of the individual. In the case of the capital gains, that income is taxed at a special rate which, at present, amounts to 25 per cent. For most investors, this rate is less than their marginal income tax rate; and, thus, a tax inducement is given to taking income in that way.

This differential is probably favorable to business expansion. If an individual, for example, has an income which gives him a marginal rate of 70 per cent, he may well decide to dispose of some income-paying securities and invest the proceeds in a new enterprise. Such an enterprise is not likely to pay returns

for a few years; but if it is successful, the investor can sell his interest at a later time, paying a tax of 25 per cent on the gain realized instead of the 70 per cent rate applicable to ordinary income. Of course, we recognize that, as long as we have the corporation tax, there is still a double taxation on this income; for the earnings of the corporation, which presumably gave rise to the enhanced value of the shares, had been taxed, and then the resulting enhancement of value is taxed again. But if we assume the existence of the corporation tax, then the capital gains tax is more favorable to the investor than would be the personal income tax at present rates.

In this respect, the differential in favor of capital gains is to be endorsed; it is desirable that individuals in the higher income brackets should be encouraged to use their funds as venture capital rather than to keep them invested in seasoned securities or bonds at the minimum of risk. This should be done because, in the first place, an expanding economy needs more use of funds in this way and because, in the second place, it is desirable, as a matter of social "division of labor," that the greater risks should be taken by the persons of larger incomes and that the holding of safe investments should be left to the persons of smaller wealth and income.

Therefore, while the taxing of capital gains at a lower rate is subject to the objection of lack of uniformity and thus to the general objection expressed above regarding special types of incentive taxation, it is, no doubt, to be recommended as long as the rates on the higher brackets of personal incomes remain at their present high levels.

## SALES AND EXCISE TAXES

From the point of view of incentives to expansion, sales and excise taxes have a less direct effect than almost any others. The main objection to them lies in the realm of equity, since, if they are to be highly productive, they must almost necessarily be regressive. They also have their effect upon the aggregate of purchasing power. The effect of special excise taxes upon the demand for particular articles depends upon the elasticity of demand for those articles: the greater the elasticity, the greater

the effect on volume and perhaps on unit costs and prices. In general, however, these effects are farther removed from immediate decision making and, therefore, are less objectionable from the point of view of getting desired action from business enterprisers than taxes on business incomes or extremely high surtaxes on personal incomes.

Moreover, the objection to sales and excise taxes on the ground that they are regressive may lose its force when these taxes are viewed in the setting of the whole tax system. If, for example, it is believed that the personal income tax is too highly progressive, that feature might be remedied by the imposition of sales and excise taxes, which would have a countereffect. Such a method of correcting the undue progressivity of one tax can hardly be commended on the basis of neat logic, for on that ground the proper reform of a too highly progressive tax consists in the rearrangement of the rates of that tax. But it may be found that to correct the assumed shortcoming of the income tax itself would involve such difficulties and such high costs of collection as to make it impractical. This latter objection, however, is partly met by the withholding device, which is now employed in collecting the income tax from wage and salary earners; and thus there is less justification for the use of sales taxes for this purpose. The chief justification, therefore, which remains for these taxes must be in their low cost of collection, their great revenue-producing potentialities, and the fact that the revenue yielded by some of them is remarkably stable.

## ESTATE AND INHERITANCE TAXES

The federal government levies taxes of a progressive nature upon estates. In addition to these taxes, the several states commonly levy taxes upon inheritance. The distinction between the two should be noted. The former adjusts the rate to the amount of the estate left by the deceased, whereas the inheritance tax, in the strict sense of the term, adjusts the rate to the amount received by the beneficiary. From the point of view of equity and of discouraging the concentration of wealth, the second principle would seem the more valid. From these points of view the community should be concerned, not with the amount of the

entire estate which is bequeathed, but with the way in which the estate is distributed and the effect which the inheritance has upon the tax-paying ability of living persons.

The chief argument for taxation under either of these principles is that it discourages the concentration of inherited wealth. There is much to be said for this objective in a society which believes in encouraging equality of opportunity. From the point of view of incentives, there are opposed considerations. On the one side, it may be argued that the chief incentives for expansion of business activities lie in the effect of these activities upon the individual's own income and wealth rather than on that which he bequeaths to others. This argument is based on the belief that, although investors and enterprisers are not indifferent to the fortunes of their heirs, the venturing of funds, time, and effort in new projects or hazardous expansion is more commonly undertaken during the early or midyears of a business career and in those years the interest in leaving an estate is not highly developed. The argument continues that this interest is more highly developed among older men but that those men will, in any event, have a strong preference for secure investments rather than for venturing their funds in expansion. If that is true, the prospect of inheritance or estate taxes would have relatively little effect upon business expansion.

Opposed to this rather favorable view of the so-called "death taxes," there are substantial arguments. First, there are, no doubt, notable exceptions to the picture just presented of shifting incentives during the person's lifetime. In some cases, the prospect of leaving a substantial estate may be a strong incentive even among men of youth and middle age; and, on the other hand, some men of advanced age will still be interested in venturesome activities. Second, it may be argued that, if the natural tendency of older men is toward conservatism, that tendency should not be accentuated by levying such heavy taxes upon estates as would still further discourage constructive investment. And third, there are those who argue, with considerable reason, that the problem of concentration in the ownership of wealth and in the control of business enterprises should

be attacked by more direct methods and that the tax system is a clumsy device for the solution of this problem.

## INCENTIVES APPROACH TO TAXATION

The most important requirement for the formulation of a good tax system, which will raise such large amounts of revenue as are currently needed, is for us to recognize the important effects which taxes may have upon economic incentives and the total income of the community. In earlier days, when taxes were smaller (both in absolute and relative terms), it was possible to consider the question largely from the point of view of equity. Indeed, in the treatments of taxation by economists up to the last decade or two, the ideals to be sought were largely confined to the adequacy of taxes, the low cost of collection, and the requirement of equity, which was taken to mean the levying of taxes in proportion to "ability to pay." In those earlier treatments, virtually no mention was made of the effect which taxes would have on business decisions or on the total volume of production. Today this latter test of a good tax system has assumed major importance. We cannot consider the question of taxes merely as a matter of extracting the certain amounts required by the government from a fixed national income which would otherwise be available to individuals. Rather, we must continually bear in mind that the tax system will have an important bearing upon the amount of that national income.

On this question, as on so many others of public policy, it is essential that we distinguish between the ends which we have in mind and the means of attaining them. The most important end, as far as material goods and services are concerned, is to raise the general average of material well-being of the people and particularly to improve the material standard of living of the middle and lower economic groups. But an attempt to reach this social goal by the direct use of the taxing power of government is certainly doomed to failure, for such a direct attempt to determine the incomes of large groups of our people would violate the requirements of our incentives system. In this case,

as in many others, the indirect approach is required in a free society. The encouragement of the incentives of enterprisers for innovation, for business expansion, and for production represents such an indirect approach. To follow that route, rather than the more primitive direct attack—in short, to nourish the goose instead of killing it in a hurried effort to get the golden eggs—obviously requires a certain degree of political maturity on the part of a people who have in their hands the potent weapon of the taxing power of government.

# 17

## *LABOR-MANAGEMENT RELATIONS*

THE labor problem of this country can be defined in a number of ways. In its most extensive sense, it is the problem of improving the well-being, material and otherwise, of the workers of the United States. From that point of view, its only solution, as we have pointed out before, is to increase the productivity of the whole economy. The problem can also be regarded from the point of view of the well-being of a narrowly defined group, such as industrial labor. In this case, also, the most promising line of attack is to increase productivity, although it must be admitted that some gains can be made for such a group at the expense of other large groups in the community—for example, farmers, self-employed, clerical workers, and owners. And so one could go on identifying the problem with the interest of broader or narrower groups.

The problem can be regarded more specifically as that of the relations of labor and management; and, in this sense, too, it has various aspects. Of all these definitions, the one which is specially pertinent to our main inquiry is this relation between management and labor and its bearing upon the incentives to business enterprisers to expand their activities and thus expand the volume of investment, employment and production.

### COMMON INTERESTS OF LABOR AND MANAGEMENT

Competition, which we have said must be the main regulator of economic affairs in a free market system, should take a number of forms and should generally permeate the whole society. In this broad sense, competition provides alternatives between which everyone—as producers, consumers, employers, workers, or investors—can exercise his free choice. There should be competition between those who supply goods and services to the

enterprise. And another obvious and important form is the competition of enterprises one with another. In this struggle for survival and advancement of individual enterprises, all of the participants have joint interests. The common interests of managers and owners are plain enough, but that they also include the interests of the workers is not always so clearly recognized. A recognition of this community of interest underlies any reasonable treatment of the so-called "labor problem."

There are two aspects of labor as a factor of production. In the first place, it is like a commodity in that there is a supply of it, there is a demand for it, and it has a price. In this view, it can be employed (purchased) to perform certain specific actions. It might even be regarded as interchangeable between employers; and, therefore, it might be argued that the worker who "sells" his time has no more direct interest in the success of the particular employer who hires that time than the manufacturer of bricks has in the success of the company that uses those bricks in its building.

There is some truth in the commodity view of labor; and, even according to this narrow view, there is a mutuality of interest between workers and capitalists, since they are supplementary factors of production; hence, a supply of one tends to create a demand for the other. But this concept of labor as a commodity is far from being complete or realistic, and for several reasons. First, labor is not something that can be disassociated from the seller of labor. A potato farmer sells his potatoes and has no further interest in what is done with them. But a worker entering employment is undertaking to devote part of his own time (actually part of his life) to the job. Because of this fact, the conditions of employment become important in an entirely different way from the use of a commodity which can be separated from individuals. A further reason why this commodity view is inadequate is that there is not perfect mobility of labor. Men are not readily interchangeable. From the worker's point of view, his employment determines the place in which he will live and the social environment for his family; and the ties to certain communities are not easily broken. From the employer's point of view, time is involved in the training and adjusting of

a person to a job, and it is recognized that a high degree of turnover of labor impairs the efficiency of a producing organization. Continuity of employment thus becomes desirable and, at least in some degree, essential to both parties of the work contract. But if, for these reasons, the worker is more or less tied to a particular employment and an employer is tied to particular workers, the consequence is that they are both dependent upon the success of the particular enterprise.

Another reason why the hiring of labor is different from the engaging of other necessary elements of production is that in the relation of workers one to another we have, to a certain extent, through the development of labor unions, abandoned the principle of competition. As to some aspects of the worker's position, particularly his wages, we permit combinations of workers for the purpose of making concerted demands upon employers. We are thus permitting and, indeed, encouraging workers to follow policies which, if pursued by manufacturers or other businessmen, would speedily bring them into conflict with the antitrust laws. Whether this is good or not is fruitless to discuss, for it is an accomplished fact. The result of this fact is that we are substituting group bargaining for individual competition, and, consequently, such bargaining must involve negotiations and concessions if the productive activities of the enterprise are to go forward. The pressure which both sides will feel, causing them to enter upon negotiations in a sincere effort to find a solution, depends upon their recognition of their mutual dependence. If the employer recognizes clearly that it is highly important to him to have a working staff of people who are well satisfied with their lot and who would consider it a serious misfortune to sever or disrupt their relationship with the company, he will be impelled to make such concessions as are necessary to bring about that state of mind. If, on the other hand, the workers recognize that their success in attaining the ends which they desire are dependent upon the effective functioning of the enterprise and its economic success, then they, too, will be inclined to make such concessions in their demands as will contribute to that end. In other words, the hope of attaining agreements, and of doing so without costly strikes and disruption of production,

depends upon a recognition by both sides of the mutual advantages of harmonious relations. The development, then, of collective bargaining, which apparently has extended to about one-half of the nonagricultural employment of the country, provides an additional and urgent reason for a conscious recognition of these common interests.

The interdependence of particular employers and workers is probably greater today than in previous times, for it has been enhanced by a reduced rate of labor turnover. This trend toward permanence of employment has been partly encouraged by employers for the reasons mentioned and also by certain policies of labor unions, particularly their emphasis upon seniority, and retirement plans. In view of this increasing interdependence, it seems strange that the recognition of mutual interests between employers and employees is probably at a lower level than in previous times. Indeed, the attitude is altogether too often one of opposition, if not of hostility. No doubt there are a number of explanations for this, but it is not necessary to develop them here.

But since there is altogether too frequently a failure to recognize these common relations, it will be worth while to examine in some detail the relation of workers and managers within the individual enterprise. We can more readily see these relations in the microcosm of a small enterprise than when we deal with the thousands of workers of a large company. Let us, therefore, set up such a hypothetical small concern. We shall call our hypothetical enterpriser Henry Smith and shall assume that he has had some experience as a baker, that he has accumulated a small amount of capital, and that he now desires to establish a business of his own. He finds two other men in the community who have confidence in him and who are willing to enter a partnership in which they will provide some of the necessary funds. The partnership buys or rents a building, lays in a stock of materials, and purchases equipment. The partners then borrow money from the bank or a local capitalist, giving their note or mortgage as security. Next, they hire a salesman, who calls upon the local retailers and lays the basis for sales. Then they hire an experi-

enced baker, whom we will call Joe, and another man to be his assistant and man-of-all-work.

Now our organization is set up and ready to go. If we should ask the question: "What can Joe do to contribute to the expansion of this bakery business?" the answer would not seem to be too difficult. It would be clear that Joe should work faithfully and intelligently, that he should economize in the handling and use of materials, and, in general, that he should strive for good products and low costs. It would be expected that Joe would recognize his interest in the progress and success of the enterprise. In a sense, whatever the contract of employment may state, the employee is in business with his employer. These relationships would seem clear enough, and probably there would be no need of talking about them.

As to wages, it is to be expected that Joe will look after his own interests. His main reason for engaging in the enterprise at all is to provide an income to take care of himself and his family; and naturally, he is more concerned about them than he is about others. He will not accept less than he might receive elsewhere, and, indeed, if he is leaving an established firm to work for this new venture, he may insist upon more. On the other hand, the employer will probably not pay him very much more than he would have to pay some other baker. These two figures, however, are both flexible because not all bakers possess equal efficiency or dependability and, from the worker's point of view, not all employers are equally agreeable and pleasant to work with, nor are the prospects of advancement equal in all situations; and, of course, there are other variables.

Even if Joe enjoys a sort of local monopoly in his kind of service, because of local conditions or unusual scarcity of bakers, he will recognize that there are limits to the bargaining pressure that he can reasonably exert. For one thing, he will recognize that the enterpriser must have a reward or at least a reasonable prospect of a reward. If the project is successful, the enterpriser ought to receive more than Joe because, if it is not successful, he will receive nothing and may lose everything put into it, while Joe must be paid anyway. Joe will probably recognize also

that the silent partners must likewise have their reward or prospect of reward and that this reward must be not merely a fair return of interest on their money but a return high enough to balance the very real possibility that there may be no return at all and, in fact, that the partners may lose part or all of their investment. He will probably also recognize that the bank or the local capitalist who loaned the money must be paid interest. Then, the salesman and the delivery boy must be paid.

Taking all this into account, we know from innumerable experiences that some mutually acceptable arrangement will be reached as to Joe's wages. This arrangement is a purchase and sale bargain, but it is even more than that. The concept of a team is involved because Joe, like all the other members in the enterprise, having entered this project would have an interest in its success.

It is true that the several participants may be more or less directly affected by success or failure, since in case of failure the priority of their claims will differ, and these differences are balanced by corresponding differences in rewards in case of success. But Joe will see that, despite such legal safeguards as workman's liens, he cannot get a continuing and satisfactory income and security out of a failing business.

At the same time, the employer in this case will be keenly aware of the importance of the satisfactions which his baker derives from his employment, for the worker cannot be easily replaced. Especially is this true if the baker has developed a loyalty to the concern and has taken an intelligent interest in its problems. Thus, if these men—employer and employee—truly recognize their mutual dependence, their self-interest will cause them to give due regard for the primary interests of the other. This mutual self-interest is, after all, the best basis for decent and self-respecting relations of the parties in any joint undertaking.

This simple illustration may serve to indicate some of the fundamental relations between labor, management, and investors in private enterprise. For one thing, it suggests that the groups are participating in the enterprise on different terms. Some have prior and specified claims on the fruits of the enter-

prise; others get residual and variable shares. The investors have the prerogatives and responsibilities for direction, and this seems fitting both on the ground of specialization of function and on the ground that their gain or loss depends most directly upon success or failure of the enterprise. But, at the same time, all participants have a real interest in the production and the efficiency of the project and will serve their own interest by serving the whole. Thus, while there will be a labor problem, in the sense that a problem always exists when divisions of proceeds between free men are involved, it should not be too difficult to solve.

To bring about a recognition of these relations is a prerequisite for a satisfactory solution of the labor problem in a free society. It is not the only requirement, but it is an essential one. There will still be differences to be adjusted over the division of the proceeds. Individuals may reasonably dispute over the dividing of a pie, but they will not be acting intelligently if they let their disputes and animosities over that question reduce the size of the pie itself, for even a very large share of a small pie may not be very nourishing.

The baker, Joe, in our illustration would see this readily enough; to get the thousands of Joes in a plant (where conditions of high division of labor and specialized functions exist) and the millions of Joes in our whole industrial system to see those basic relations is a problem for labor leaders, who aspire to statesmanship instead of political manipulation, for industrialists, educators, and all who wish well for an expanding and fruitful economy.

The mutual interests of employers and workers are detailed and should be more specifically noted. First, one common interest is in an expanding business. It is true that the growth of an enterprise will not inevitably and invariably lead to the improvement of the lot of every individual concerned. But, broadly speaking, there will probably be little dissent from the proposition that it is better to be associated with a growing concern than with a dormant or declining one. From the worker's point of view, this advantage will appear in a number of ways. One way is in his assurance that the prospect of continued employ-

ment through good times and bad will be enhanced by the growth of the enterprise. Assuming that the expansion of the firm is made on sound business grounds (that is to say, in such ways as will provide a reasonable margin of safety between costs and revenues) and that the financial structure is such as to strengthen the institution against the effects of unfavorable business conditions—assuming all this—the growing concern has a better prospect of weathering, through its own momentum, any economic storms which it may encounter than does the organization which was only holding its own in fair weather. This assurance or increased probability of the "seaworthiness" of an enterprise is fundamentally more important than any specific guarantees of employment. Another reason why the worker has an interest in the expansion of the enterprise is in the opportunities which it provides for his own advancement. It is possible, of course, for a worker to make progress by moving from one level of employment in one concern to a higher level in another concern; but it is obviously better if the opportunity for moving to higher levels also exists within the one concern. Just as it is wise for a young man to enter business in a geographical area in which economic activity is growing, so it is evidently better, from the point of view of advancement, for a worker to be associated with a growing concern than with a stationary or declining one. As we remarked before, the importance of this factor is enhanced by the several forces which have tended to reduce the mobility of labor. These, it will be recalled, include the natural attachments which workers have to certain communities, the increasing use of seniority and retirement plans, and the increasing recognition by employers of the high costs involved in labor turnover.

Secondly, the worker has an interest in the profitableness of an enterprise. Just as it is better to be connected with a growing concern than with a declining one, so is it better to be employed by a profitable concern than by an unprofitable one. The latter is perforce niggardly in its treatment of all participants—labor as well as stockholders and managers. This is not to imply that the wages of workers should be closely tied to the profitableness of the particular concern. The widespread adoption of that prin-

ciple would have potent disadvantages from the point of view of labor itself. Moreover, if it were carried far, the incentive for the entrepreneur to improve his efficiency of production, his sales efforts, and so on, would be reduced because gains in those directions would be neutralized by increased wages. Nevertheless, as a practical matter, it must be recognized that we cannot "get blood out of a turnip" and that, regardless of the inclination of the employer to pay his workers well (perhaps somewhat better than the going market rate), he will be unable to do so if the concern is not operating successfully, that is to say, profitably. As every labor leader knows, the first requirement of securing wage advances is the economic possibility of the concern to pay them.

In the third place, both the employer and the employees have a keen interest in continuous employment. It is true that this continuity can be impaired by factors outside the control of the workers or the managers. But when market conditions permit production and employment, any interruption by virtue of disagreements between employers and workers over the terms of employment is costly to both sides. This point, of course, is recognized in general terms, but its significance at times seems to be overlooked. For example, a certain large industrial strike which continued for some four months and resulted in the settlement at a wage only slightly higher than could have been agreed upon at the outset was widely hailed as a victory for labor. The plain fact seems to be that it would require three years of employment at the higher rate to make up for the wages lost during the strike. When it is observed that in this particular company the average length of employment is less than two years, it appears that the importance of continuity was not fully appreciated. On the other hand, the loss to the employer in the sales which went to competitors and the loss to the community in the reduced supply of desired production cannot be so readily measured; but they, too, were heavy indeed. Industrial warfare by means of the strike or lockout is very much like modern international wars in which it has become very difficult for either side to win in an economic sense.

A fourth condition of employment in which both the em-

ployer and the worker have a stake is a personal interest in the job. The importance of this feature is suggested in our illustration of the baker and his small enterprise. From the point of view of the employer, such a personal interest by the worker is almost bound to contribute to his effectiveness; and from the point of view of the worker, it provides a basis of personal satisfaction. This personal interest in the work itself is probably more difficult to attain in a large and highly subdivided industry than in the small concern. This fact itself constitutes one of the most important problems in industrial relations. General education, better information concerning the activities of the company as a whole and its competitive relationships, and perhaps a compensation system which rewards initiative and performance may help. This is not the place to deal with the problem of the relation of the worker to his work except to say that its solution is perhaps the most important psychological problem in a highly industrialized society. The importance of the solution to this problem will be suggested by the fact that never before in the history of the world has so large a number of people been employed for wages and by the obvious fact that a considerable amount of the workers' time is devoted to such employment. For such a large section of the population to achieve a sense of satisfaction from the part played in production itself, as well as from the fruits of that production, is quite evidently an essential requirement for attaining the ideals of a good society. The problem is, therefore, of fundamental importance not only in its economic implications but also in its political significance and in the establishment of the psychological health of a country.

The fifth mutual interest of management and labor is that the quality and quantity of the day's work be clearly defined and that this definition be fair and reasonable. The worker should not be expected to work at a higher rate or level of production than he will be able to maintain in health and efficiency over an indefinite period of time. On the other hand, the standard should not be so low as to result in the worker's producing less than he knows he is well capable of doing. To violate the former requirement is uneconomic from the point of view of both a long-time employer and the community; and to violate the latter

is frustrating and stultifying to the worker. The actual definition of a "fair day's work" which will meet these basic requirements will not be too difficult if management, laborers or their representatives, and government approach the problem in full recognition of these mutual interests.

A sixth point of common interest is that workers should be assigned to jobs on the basis of their abilities and potentialities. The square peg in the round hole yields no lasting satisfaction to workers and certainly does not contribute to the effectiveness of the organization. Another aspect of this requirement is that workers should be provided opportunity to develop and advance within their companies. From the company's point of view, it is better to fill the more responsible positions from the present personnel because much more is known of the abilities of the candidates. Moreover, such promotions provide incentives to others and tend to energize the whole staff. From the worker's point of view, the promote-from-within policy means opportunity. The realization of these interests is complicated by inadequate ability to measure human capacities; but it is also complicated at times by indifference and lack of intelligent effort on the part of management and by certain union policies, among which are the extreme and rigid applications of seniority rules. These rules have too often represented an effort to avoid healthy competition by removing a prime incentive to the young, able, and energetic. In such cases these rules are in a class with all efforts to restrict output and hamper enterprise. They may serve the interests of the less efficient by providing enhanced security, but it is doubtful if they advance the interests of labor as a whole.

Workers and employers have a seventh common interest in satisfactory "government of the shop," that is, the establishment and administration of rules of conduct on the job. Especially in large enterprises, the direction and co-ordination of the activities of individual efforts become a major problem. Such government of the producing unit must involve a certain degree of discipline for the benefit of the whole enterprise. In this objective the workers and managers have a direct interest because it affects the conditions of work as well as their indirect interest in productivity and the effectiveness of the enterprise. The re-

quirements are that such government should be not only efficient in the narrow sense but also fair and reasonable, to command respect and acceptance. This means that the government must be equitable and humane (implying by the latter term not laxity but that the methods of supervision should take into account the fact that we are dealing with human beings and not with automatons). Instances could be multiplied—and would include some of our very largest organizations—in which a striving for efficiency in the narrow sense has led to inefficiency in the net result because of a neglect of the fundamental needs of men for self-respect and self-motivation. To try to buy the loyalty of workers merely by paying good wages and by providing clean washrooms is shortsighted when management fails to provide that other essential of treating individuals as human beings. To fail in that respect simply means that management is not getting its money's worth—that it is, through lack of real understanding of the human element in industry, wasting its money on high wages. It is not possible, of course, to satisfy this mutual requirement by any formula; but much can be done by managers through better selection, development, and guidance of foremen and other supervisory personnel.

All of these points of mutual interest suggest the importance of what has come to be known in recent years as the "problem of industrial relations." That problem is essentially one of attaining effective organization and co-ordination of activities and establishing such human relations between workers themselves and between employers and workers as will contribute in the broadest way to effective work.

Unlike many other functions in competitive businesses, the maintenance of such wholesome relations is one in which success in one enterprise is aided by success in others. And conversely, through the transfer of workers from one enterprise to another and the formulation of policies by unions which include workers from several concerns and by other contacts, the effects of bad relations in some plants are extended to others.

The contagious effects of good or bad human relations in industry suggests the propriety of co-operative effort, through conferences and pooling of information, and the provision of

advice by such quasi-public organizations as the several university bureaus of industrial relations. The establishment of wholesome human relations throughout industry is like the problem of establishing good physical health, in that progress made in one plant facilitates progress in others. Here is one of the aspects of management which, even in a competitive industry or society, can well enlist the co-operative efforts of competitors as well as of managers and workers within the single unit.

## LABOR RELATIONS AND INCENTIVES FOR ENTERPRISE

So far, we have seen that the interests of employers and employees in the conditions of employment are essentially not opposed but, in many respects, common to both groups. A recognition of this fact is perhaps the most important requirement for the establishment of such relations as will contribute to a favorable environment for economic expansion. But there are certain other conditions.

Since labor is one of the most important factors of production, an adequate quantity of the particular kinds and types of labor needed is one of the most important conditions for making possible the expansion of enterprise. Another requirement is that the quality of labor should be such as to contribute to a high degree of productivity. The quality of labor available in the United States is, by comparison with foreign standards, generally very good. We have a large number of workers who are accustomed to and fitted for industrial employment. The general average of health and physical condition is good, as is also the level of education and training. The result of these factors is that the typical working level or "tempo of the shop" has been noted by various industrial engineers to be superior to that of most other industrial countries. The qualities of labor needed for a dynamic economy include not only the obvious ones of diligence and ability to understand and follow directions but also initiative and adaptability. Ready acceptance and co-operation of labor are particularly needed in the use of best methods of production. A forward-moving economy will involve frequent changes in methods of production and the tasks of labor. Some of these changes are minor, but even these require

an attitude of mind that is not too much marked by inertia and adherence to custom. But there are also more serious changes that involve real hardship to investors, managers, and workers.

Economic progress is a process of creative destruction; i.e., when new values are created, old ones are destroyed. The carriage industry and its capital equipment were destroyed as the automobile industry was built. Not only capital values are thus destroyed, but also the values of special skills which have sometimes been built up by workers over long periods of training. The impact of this destruction of specialized skills can and is being reduced in several ways. In the first place, the slowly acquired craft is less important in the industry of today than in that of a generation ago. Because of the high degree of division of labor, it does not take so long to train or retrain an automobile worker as it did to train a carriage maker or a cabinet maker. In the second place, large companies appreciate the cost of labor turnover and make definite efforts to fit workers who are displaced from one type of work into another. Thirdly, government-sponsored programs, particularly for unemployment compensation and employment service and retraining, can help to ameliorate the necessary cost of progress. But even with all these modifying factors, change is bound to involve burdens, and in a free society they can never be equally borne by all. At the very best, there will be an element of uncertainty. Therefore, in addition to such private and institutional remedies as may be devised, a certain spirit of adventure and ambition is required by workers to overcome their natural inertia and preference for doing things in the old way. This psychological attitude of workers cannot be dissociated from that of the whole community. It is probably true that venturesome characteristics are more pronounced among Americans generally and American workers in particular than among the people in most other countries. But there are some indications that these characteristics are giving way to a greater emphasis upon security and routine. This is a problem for the whole society, for, fundamentally, progress is not attained as a result of security seeking. On the whole, American workers have readily accepted and

adjusted themselves to changing technology. But there are also many instances of attempts by organized groups to block the introduction of mechanical improvements and some aspects of scientific management. Such resistance should be discouraged and kept to the lowest feasible minimum. Moreover, the members of some trades place obstacles in the way of outsiders entering those occupations. In so far as this practice is followed, it closes the doors of alternative employment for men who may be dislodged from other industries, and thus provides a logical basis for them, in turn, to try to protect *their* jobs and skills. Such policies represent efforts on the part of each group to attain security at the expense of the others. The net result may well be not to increase security generally but only to check the rate of change upon which a rising standard of living must be based.

Wage adjustment is obviously an important aspect of management-labor relations, though we have seen there are many others. From the point of view of the business enterprise, wages paid are a cost and often the most important single element of cost. Viewed in that light, they must always be considered in relation to what is received for them, that is, in relation to the productivity of the labor. These two factors, wages and productivity, together determine unit labor costs. The enterpriser is not concerned with wage rates as such but with the cost of labor for a given quantity of output. The requirement for expanding employment and production, then, is that wages should be adjusted to the productivity of labor. But this general statement requires explanation. In the first place, labor is not a homogeneous thing: it is the services of individual human beings who differ widely in ability and motivation and, hence, in productivity. Ideally, therefore, wages should vary from one person to another. Under conditions of modern industry, and quite aside from union rules, it is not possible to realize that ideal literally, but departures from it should be regarded as concessions to practical requirements, not as desirable in themselves. Secondly, productivity, both in a physical and value sense, varies from time to time; and in order to make the employment of workers attractive to enterprisers, the wage should be correspondingly flexible.

Thirdly, the productivity of labor varies from one country to another and from one region or locality to another, depending partly upon the quality of the workers themselves and partly upon the supply of the other factors (notably capital) which must be combined with it. In the interest of expanding business and employment, wages should likewise vary from place to place. Efforts to establish by law or by industry-wide agreements uniform wages which are adjusted to the levels of the more advanced areas would only discourage the demand for labor in the backward areas, delay the flow of capital and enterprise into them, and thus defer the time when higher wages and full employment could be established there. In the fourth place, the statement that wages should be based on productivity refers to the general productivity of labor, not to the productivity of each employing unit. To base wages, to any great degree, upon the economic success of the particular concern, and especially to do so by force or by the threat of force, is to weaken the incentives of management to make the most effective use of labor. If employers A and B are employing the same quality of labor in the same area at the same time, they should be able to do so at approximately the same rate. Employer A should not have to pay more than B because he has made more profitable use of his resources; nor should B be able to get labor at less than the going rate because he is unable to use it as effectively, that is, as profitably.

Another positive incentive for enterprise is the maintenance of reasonably pleasant and co-operative relations between employers and workers. This refers, not especially to the economic results of such co-operation, but more to the fact that continual bickering and strife is in itself a deterring factor to enterprise and one that particularly affects small enterprises, for the reason that the personal relations of employers and workers are more intimate in such concerns. The basis for such satisfactory relations lies in the establishment of good industrial relations and in a mutual recognition by workers and managers of those common interests which we have discussed.

Another incentive for enterprise, which is in part non-economic, is the desire on the part of the enterpriser for independ-

ence. This interest (as we have observed in a previous chapter) is one of the reasons why men choose the role of enterpriser instead of that of employee. To attain this position does not require unlimited power on the part of management; indeed, an effort to attain that objective would no doubt interfere with some of the other requirements which we have recognized, but it does mean that there should be some reasonably broad and well-defined areas within which the judgment of management must be final. This feature of a favorable environment for economic expansion is thus directly affected by demands which have been made in some quarters for an increasing share on the part of labor in management. In so far as this implies a greater co-operation of labor and management, looking to the success of the enterprise, as it often does, it is surely to be commended. But the ultimate responsibility of management and the freedom of action which that responsibility implies must be preserved if industry under our economic system is to function effectively.

## COLLECTIVE BARGAINING AND INCENTIVES FOR ENTERPRISE

In recent decades there has been a strong tendency in the United States, as well as in other countries, toward the organization of workers into unions and the extension of collective bargaining. This tendency is but a part of a more general movement throughout Western countries to minimize the impact of competition between the individual members of the same economic group and to conduct the negotiations, as to the terms under which these different economic groups will co-operate in the whole economic process, through groups instead of by individuals. To some extent, this tendency in labor is encouraged by the increasing size of enterprises which makes it impossible for the employer to make individual bargains with his workers. The feasibility of such individual bargaining declines as concerns grow in size, and it becomes increasingly necessary to employ workers for a certain purpose on some standard wage and contract of employment. There are, of course, other forces of a political and social nature which have stimulated the movement toward collective bargaining, but this requirement of employing

workers in large numbers is one which is necessary even from the point of view of the employer.

We do not need to attempt a detailed explanation of the causes of collective bargaining, nor even to consider the general economic consequences of that move. We are concerned particularly with the effect which it will have upon the expansion of enterprises and the preservation of individual freedoms. From the first point of view, the labor union is commonly regarded as a negative factor. We do not wish to emphasize that point. It will be more fruitful to look at the positive ways in which unions can contribute to an expanding economy. In general, union policies which emphasize the common interests of employers and employees, as well as their divergent interests, would be helpful. In some industries, particularly garment making and others where the employing units are many and small, a commendable effort has been made by unions to advance mutual understanding and recognition of mutual interests. In many other industries, however, the attitude has been one of extreme hostility. The publications of the unions and the speeches of their leaders frequently leave the impression that the employer is the worker's worst enemy.

To some extent, this attitude may be but a passing phase which marks the natural militancy of a new movement. To some extent, also, it probably reflects the efforts of individual labor leaders to maintain their positions of power within the organization. We have had many occasions to observe that a leader can frequently maintain and strengthen his position by convincing his followers that the people "on the other side" are their enemies and, therefore, that unqualified loyalty to him is essential for their protection. This device is commonly employed by political dictators, and this explanation of the continual fanning of the embers of discontent and the stimulating of an attitude of hostility is not altogether irrelevant to the corresponding policies of some labor leaders. It is possible that, as unions become more firmly established and as the leaders themselves feel a greater degree of security in their position, these antisocial devices will decline. That situation at least is to be greatly desired, for the concept of an armed truce or active war-

fare as the normal relation of workers and their bosses is quite inconsistent with the healthy functioning of a free enterprise system or indeed of any system.

Generally, collective bargaining has so far meant the advancing of demands on the part of workers and the resistance to those demands on the part of the employers. There are some indications that the device of collective bargaining can also be used constructively by the employer to set forth his desired policies and to enlist the co-operation of the union in carrying out those policies as part of a two-sided bargain. To accomplish such a result requires economic maturity and a willingness to face economic realities on the part of union members, plus a higher degree of economic statesmanship on the part of labor leaders than many of them have shown in recent years. On the part of employers, it requires a shift of emphasis from opposition to collective bargaining to the use of that device for advancing their own views and policies.

Collective bargaining can thus be used for advancing the co-operation of workers and management in their common objectives. At the same time it must be recognized that there are divergent interests between management and labor and that, for the health of the economy, there could readily be too much harmony between them. If this seems unlikely, we should remember that no society can afford to let any one group fix its own rewards. To allow such unbridled power would be to place too great reliance upon the sense of public responsibility of human beings. There are three general ways in which this result can be avoided. First, it is possible that the organized society, that is, the state, should act as the arbiter in conflicting claims. This is, however, an authoritarian solution which should be kept at a minimum in a free society. A second way is by competition between the members of one economic group for the patronage of the members of another group. This is the chief device of the competitive society. Third, in so far as this competition is diminished, we come to rely upon bargaining, and then the protection of the rest of the society against the claims of any one group must lie in the resistance of the persons or groups on the opposite sides in the bargaining. Since the de-

velopment of labor unions does represent a considerable diminution of competition between individual workers, we must rely more and more upon this third protection.

Hence, while the common interests of employers and employees can, as we have seen, provide the basis for a commendable degree of co-operation in effective production, it is quite conceivable that these interests can lead to policies of wage raising, price raising, and restriction which will be inimical to the interests of the general public and which will have the effect of restricting the possible expansion of production and employment. In the long run, such policies are opposed to the interests of the workers and employers themselves. But those bad results are far removed and, indeed, may apply chiefly to potential manufacturers and potential workers, with the result that they are of relatively little present concern to employers and workers. There has, at times and in some industries, been a sentiment upon the part of employers that they were not greatly concerned with wage rates as long as their competitors had to pay the same rates. In some quarters this is regarded as a commendable attitude of co-operation between workers and employers. Such a compliant attitude has reportedly gone farther in England than in the United States. The coal-miners, for example, might form a strong union and demand an advance in wages; the mine operators lose their power or spirit of resistance, form a cartel, and as a group accept the higher wage, passing the cost on to the consumer in the form of higher prices. Such a solution in one industry leads quite naturally, through the cost-of-living argument, to a similar solution in other industries; and the result can well be a progressive advance in costs and prices. Difficulties arise when, to follow our illustration, the mine operators try to sell their coal outside the country, where they must meet the competition of producers who have not resorted to such a pleasant solution of a difficult problem. The answer to that dilemma is, of course, to form an international cartel. If that is impossible, another solution may be to strive for a closed economy through protective tariffs and other restrictive devices which contribute to a decline in productivity all around.

A similar situation might develop in a local community where construction workers who are strongly unionized enter

into agreements with the contractors of that community and provide that they will work only for those contractors and that the contractors will employ only union men. Such an arrangement could well lead to high wages for established workers, on the one side, and high fees and profits for the employers, on the other. But the local community would be the loser both in its supply of housing and in its volume of employment. Therefore, if we start with an overt or tacit collusion between employers as a group and workers as a group, we set up artificially high costs, which in turn require for their maintenance other limitations upon competition. The results are necessarily restrictive and, thus, so far as they go, inconsistent with the requirement of an expanding economy.

## LABOR UNIONS AND COMPETITION

Such devices as we have described may be met by an extension of the antitrust laws to the relations of employers and workers as well as to the relations of employers to one another. But a better solution would seem to be to maintain some degree of competition, if not between individual workers, then between relatively small groups of workers. In this case the economic interests of one group act as a check and restraint upon other groups. Where the bargaining group consists of the workers of one company, there is a restraint growing out of the fact that if wage rates are pushed to unreasonable levels that company is weakened in competition with others. As against this extreme use of power, owners and workers have a common interest which is not too indirect and vague to be effective if the facts are known.

The so-called "company union" has been in ill repute for a number of years. The basis for this antagonism was the control and influence over such organizations by some employers. If we are to accept the principle of collective representation of workers, we must preserve the integrity of the workers' organization and make sure that it is not intimidated or improperly weakened by devices of the employer. But despite abuses of power under some of the old-type company unions, we should recognize the merits, under proper safeguards, of a type of collective bargaining which is based on the mutual interests of

workers and owners in the individual firm. In attempting to guard against the abuses of the company union, we may have gone too far in encouraging the growth of industry-wide organizations which weaken, if they do not completely deny, the ideals of common and co-operative efforts of employers and individual workers.

We also have gone far, perhaps too far, in weakening and restricting the competition between individual workers within the single plant or company. Perhaps, in view of these developments, the best we can hope for is that the workers of company A, along with their employers, shall still regard themselves as in competition with the workers and managers of the competing company B. If that attitude and situation is preserved, the discussions of workers and managers will be tempered by their common interest in successfully maintaining and expanding their enterprise in competition with rival enterprises. This tempering influence would be largely lost, and, hence, the protection of employers and consumers greatly weakened, if the bargaining representatives at that table are indifferent to the relative success of company A and company B. In this fact lies the basic danger of the industry-wide union. Such a form of organization carried to its logical conclusion threatens to destroy competition among workers and also the concept of labor and management in particular enterprises functioning as competitive teams.

There are those who believe that the greatest hope of arriving at peaceful and productive relations of organized labor and management lies in increasing the size and scope of unions and that the best way of securing this is in the establishment of industry-wide unions and, indeed, in the greater solidarity and co-operation between those unions. The argument is that, when a labor leader has to represent the interests of a very broad group, his attitudes and policies will be directed more to increasing productivity and less to restriction and other antisocial devices. It is thus hoped that real labor statesmanship will be developed.

It is probably true that, if we had one big union representing all labor, the leaders of that union would find little use for restrictive policies, because it would be clear that such policies,

if followed by one sub-group within the union, would be at the expense of the others and that, if they were followed by the whole group, they would obviously reduce the consumable goods and services available to all. However, such an extreme development and consolidation of the union movement as would bring that result would mean, in effect, a unified control of the economy. While it is true that such a control would not slip into the error of restricting production, as we frequently do in our mixed system, it would mark the end of a free economy with its flexibility, protection of individual liberties, and other values associated therewith.

But that extreme development is presumably not contemplated by the advocates of larger and more inclusive unions, and, therefore, the hope that the heads of these larger unions would take positions more consistent with the general welfare seems to require a higher degree of unselfishness and self-restraint than is likely to be attained.

This is not a reflection upon the intelligence, broad-mindedness, or patriotism of labor leaders in particular but merely a judgment of what may be expected of any group—farmers, businessmen, or college professors—if their power to determine their own incomes was unchecked by competitive forces. We may then join with those who hope for an improvement in statesmanlike attitudes, but also not inconsistently, urge the dispersion of power and the need for checks upon labor as on all other groups in the form of the normal countervailing forces of a competitive society.

## CONCLUSION

To facilitate these co-operative, yet competitive, relations of individual employers and their employees, management and the government can help. First, a responsibility rests upon management for conveying to workers an understanding of the work of the particular company, its relation to its consumers, and its competitive position in the market.

Second, management can more reasonably expect the co-operation of labor in so far as it really accepts the role of competition and formulates its price policy with an eye to the expansion of sales. The worker can hardly be expected to give his

best efforts to economize and to strive for cost reduction if he observes that the employer maintains his prices at levels which restrict the expansion of production and, hence, of employment. This is not to imply that labor should share the responsibility for managerial decisions; but if management hopes to secure from labor a loyal interest in the enterprise, it must follow policies that will justify that interest.

Third, another policy in this direction is more general and continued efforts to establish good personnel management. This includes the whole variety of relations which determine the position of the worker in relation to his employer. It includes recruiting, placement, discipline, promotion, and determination of work standards.

Fourth, where collective bargaining has been established, management will generally be well advised to accept that principle without reservations. The desired mutual confidence of the employer, labor leaders, and workers themselves will not be encouraged by continued rear-guard action. The policy should be one of using the device of collective bargaining in a constructive way. Collective bargaining does provide such opportunities, for in the deliberate negotiations of conditions of work there is an opportunity for a two-sided presentation of the requirements of management and labor.

The community as a whole, largely through its government, will contribute to the solution of this problem by a policy of preserving as high a degree of competition as is feasible in view of the technical requirements of modern production and certain accomplished results in the formation of bargaining groups. Moreover, as to these bargaining groups, it is a responsibility of government to hold the scales even and to restrain the natural inclination of all people to create scarcities in the things or services which they have to sell. Especially is it reasonable to expect that the government, charged with the responsibility to promote the general welfare, shall recognize that bad balance of bargaining power between labor and management will lead to unemployment and inadequate production because it will provide inadequate incentives for investors and managers, on the one side, or for workers, on the other.

# 18

## *BUSINESS POLICIES*

In considering the ways in which the incentives to expand business activities can be encouraged, one naturally looks to the environment in which business functions. But it should be recognized that a very important influence upon the functioning of these incentives is provided by the policies of business organizations themselves. Business decisions are not made merely upon the spur of the moment. They are conditioned and influenced by the established policies and points of view of the organization. To bring about a forward-moving economy, therefore, requires such policies on the part of business as will stimulate the normal business incentives and will channel and direct them into constructive activities.

### BUSINESS POLICIES AND INCENTIVES

Some of these policies directly affect the relation of the company to the market. Price policy is an example. Others have to do with the internal affairs of the company. Policies concerning selection and promotion of personnel are examples. As to the former policies and particularly as to prices, it may be urged that in a competitive society there should be little room for deliberate policy, but rather that prevailing prices should result from the operation of market forces and thus constitute not subjects for policy making but elements of the environment in which the enterprise operates. One writer has observed that policy is only relevant where competition is unattainable or inadequate.

In the production of certain staple goods by a large number of producers, this degree and form of competition can be approximated. An individual wheat farmer, for example, has no need of a price policy because he cannot influence price perceptibly. He adjusts his actions to the price. He is limited to selling

or withholding and to producing more or less in the light of an existing or expected price. But with most things, as they are produced or as they are bought and sold, there is the choice of selling more at a low price or less at a high price, of improving quality, of influencing the demand through sales efforts or of combining these various alternatives. The policies of a concern are, therefore, important for influencing not only particular decisions of that firm but, especially in the case of large ones, the environment in which others operate.

## DESIRE FOR VOLUME

In formulating such policies, one general attitude characterizes American businessmen. That is a widespread desire for volume. This desire is not merely economic in the sense that it can always be explained in terms of dollars and cents, and for this reason it is not commonly given its due emphasis by economists. The existence of this desire is shown both by the expressed attitude of businessmen and by the uses that they make of cost-reducing improvements.

On purely economic grounds, it might be expected that if an individual producer found a way to reduce costs he would continue for a time to sell at the market price and enjoy a larger margin per unit sold. Then, one might expect that these enhanced profits would attract other producers, the increased supply would force a price reduction, and thus, in this roundabout way, the benefit would finally work down to the consumer. This line of causation does in fact operate, and in some fields it is no doubt the chief way by which cost reduction causes expansion and diffuses its benefits.

But with a large number of American businessmen, the relation between cost reduction and volume is more direct. Indeed, some seem to feel—and they talk as though it were self-evident—that the important reason for cost reduction is to make possible larger volume either through price reduction, improved product, or increased sales promotion. In other words, the motivation in such cases is in terms of volume, almost for its own sake; and that result is attained directly rather than by the roundabout process envisaged by pure competitive theory.

Of course the desire for volume has its economic basis in the fact that our industry is so highly characterized by fixed plant and fixed costs that growth in volume usually does mean lower unit costs, if not in total, at least to certain parts of the operation. Hence, a policy which may have its chief roots in the competitive spirit of managers can readily be defended to stockholders because it usually does contribute to profits or to business security and is reflected in advanced market values of the company's securities. In such cases the business can be viewed as an institution—one might almost say an organism—with its own urge to growth. Since, however, it is set up to make profits, it is necessary to rationalize the real urge in terms of profits. No two business concerns, any more than two businessmen, are precisely alike, and to many of them this characterization would not fit at all. These concerns may not be influenced by this policy of growth in any very positive way, although there are few that would not be concerned by a decline in their proportion of the business. But while it is impossible to generalize for all firms, observation suggests that this urge for growth is more characteristic of American business (particularly manufacturing and merchandising) than of the business firms of other leading industrial countries and that this fact has a significant effect on the character of our economy.

## INDUSTRIAL RESEARCH

One of the most dynamic factors in the modern world is research. In the long view of history, perhaps no one development in this present age will stand out as more significant than the establishment of the scientific attitude and, particularly in recent decades, the organization of inquiry in the scientific and industrial laboratories. This general movement in the society has been reflected in the policies of American business organizations. In a number of cases, specialized departments have been established, and some of these are very large and are doing extensive experimental work both as to basic scientific principles and to the solution of practical problems involved in the production and use of the products with which the companies are concerned. The amount of such research done by private industry

in this country far exceeds that of any other country, and it has increased substantially in recent decades. But for American industry as a whole, the expenditures are still very small compared to those in certain industries which have taken the lead, and very small compared to the other functions of business. For the different industries (not individual companies) average expenditures for research activities rarely exceed 1 or 2 per cent of the total revenues, and in most instances they fall below that figure.[1] The research organizations which naturally attract most attention are those of the very large concerns, such as the Bell Telephone System laboratories, the research laboratories division of the General Motors Corporation, and several other laboratories maintained by the industrial giants. In proportion to volume, however, the expenditures for such purposes are often larger in the middle-sized companies than in the very large ones. There is, therefore, enough experience to indicate that the maintenance of formal research activities is feasible for a large proportion of American business.

Moreover, it should be borne in mind that research depends more upon an attitude of mind than upon the number of dollars or the number of specialized workers devoted to that purpose. It is an attitude of open-mindedness and self-criticism and of assuming that, regardless of the methods and products of today, there must be a possibility of improvement. When this attitude generally pervades an industry or a particular company, the ways and means of effectuating it are likely to be found. From the point of view of expansion of sales, new investment, and increased employment, probably no other one thing is more important for a progressive economy than this attitude. It is believed that one of the chief advantages of a free enterprise system is the encouragement of freedom of inquiry. Nor can research, in the long run, be successfully confined to technical matters or industrial objectives. Freedom of inquiry is not a divisible thing. It is not possible, for example, to regiment thought in some areas, such as political and economic philosophy, and at the same time to preserve it in its highest form in

[1] National Association of Manufacturers, *Trends in Industrial Research and Patent Practices* (New York, 1948).

certain desired technical and scientific areas. Likewise, freedom of inquiry is dependent upon freedom of action. For these reasons, a highly controlled society is unlikely to exploit to the full this most productive and creative aspect of the modern world. When, therefore, we stress the importance of a research attitude for American business concerns, we are in effect saying that industry should align itself with one of the most characteristic and potent forces of Western civilization.

The need for a research attitude and definite program is clearly sensed by many modern industries and companies, and the practical values of research activities have been demonstrated in numerous instances. A spokesman for the industrial laboratory of one large corporation is reported to have said that there is literally no product now being produced in the United States on which his laboratory cannot make an improvement. Such a statement is not irresponsible boasting, for the claim is founded upon the fact that the methods of analysis and experimentation are well understood and a mass of data on the properties of matter has been accumulated. This does not mean that discovery and invention have been reduced to routine. Far from it; research is still one of the great fields of adventure. But it does mean that men of imagination and initiative can now tackle most practical problems of technology with high hopes of success. This fact makes it more feasible for enterprises organized for specific business purposes to engage in such activities. At the same time, we must recall that there is a natural division of labor between such research units in business and the scientific departments of the universities and research foundations.

The effect of such policies by a few large organizations can permeate the whole field. In the automobile industry, for example, there are formal arrangements by which the discoveries of one company are made known and can be used by the others. Also, in those industries in which patent rights are exclusively employed in the operations of the owners of them, there is at least provided the stimulus to competitors to seek similarly effective discoveries. Moreover, the basic ideas provide stepping stones upon which other industries can proceed. Even so, if we are to have more centers of leadership and if we are to place large

and small companies more nearly upon an equal plane in this respect, there is need for the establishment of co-operative laboratories which will operate in the interest of an industry as a whole. The financial contribution for such co-operative research is not prohibitive even for small companies. There have been some small beginnings made in this direction, and they should be encouraged. Another device for serving more directly the small companies which cannot afford to maintain extensive research facilities is through the work now being developed in many of the state universities, either entirely at public expense or with expenses shared with the beneficiary companies. But such possibilities go beyond the range of private business policies with which we are here concerned.

## MARKET AND CONSUMER RESEARCH

While the most striking results of research by business have been in the field of new products and new production methods, there are also numerous examples of the application of this same attitude in the field of consumer demand. Such efforts involve a study of the consumer's desires for products and the translation of these desires into new products and into the control of the amount of various products produced. This policy has been described as low-pressure selling, in contrast to the all too common policy of high-pressure selling. Low-pressure selling means simply centering attention upon finding what the consumer wants, or will want if it is presented to him, and then producing that product, rather than producing what the engineers think the consumer should want and then centering attention upon selling it to him. It seems strange, since everyone recognizes that products are produced for sale to the consumer and since so much lip service is given to the doctrine that the consumer is king, that there should have been so little systematic and scientific determination of what the consumer actually wants. Needless to say, the extension of efforts along this line will be fruitful only if the philosophy which it represents is generally accepted throughout an organization. If that view is accepted, one can expect lower selling costs and increased volume; and, in the long run, it may be expected that dollars spent in finding what

the consumer wants will yield greater results than dollars spent in persuading him to want what the producer wants to sell him.

Consistent with this attitude of applying the research approach to discovering the requirements of the market has been the widespread development in the last two or three decades of private research agencies serving business firms, units attached to the sales departments of those firms, special divisions of advertising agencies, market research groups of universities, various trade associations, and the Bureau of Foreign and Domestic Commerce. The Bureau of the Census also supplies a widely expanded collection of data which contribute much to the work of these other organizations. All of these activities represent more or less successful attempts to discover, with as much precision as possible, what, where, when, and how much the mass of American consumers wants. To the extent that these research agencies succeed in answering such questions, they are furthering the aim of a free market system to maximize the freedom of choice by consumers. They also serve to uncover potential demand and to discover the possibilities of increased production to satisfy this demand. While industrial research rests upon the major premise that our productive potentialities have not been realized, this market research is based on the assumption that although human wants may be insatiable, they still have to be discovered and clearly delineated if industry is to be wisely expanded to satisfy them.

There is a widespread feeling among both consumers and industrialists that the costs of distribution in this country are too high, and some forward-looking manufacturers urge that a policy of industry which would contribute to expansion would be to try to reduce these marketing costs. Certainly one can agree that if any costs are higher than necessary it is desirable that they be reduced. But it is not so clear that the distribution cost deserves to be singled out and described as a millstone around the neck of industry. In an economy in which a high degree of specialization of production exists, and in which consumers have freedom of choice, marketing costs are bound to be high. The ideal, it would seem, is to attain the most effective distribution at as low costs as are consistent with that effective-

ness. The need for bringing many new products to consumers and for gaining greatly expanded distribution of old products requires increased, more broadly conceived, and more effective marketing efforts. But to center attention merely upon the costs of marketing is no more reasonable than it would be to center attention upon the costs of any other necessary activity of business. This specially critical attitude, however, is to be expected because unit marketing costs do not show the same tendency to decline with increased volume as do production costs.

From the point of view of effectively using available manpower in the future, the activities of advertising, selling, retail and wholesale distribution, transportation, and servicing deserve special attention. The trend of the last two or three decades has been toward the employment of an increasing proportion of our population in these lines. The number of persons engaged in marketing activities was sharply reduced during World War II. That was quite appropriate for these services are primarily needed for serving a free civilian market. But in peacetime, the consumers' needs must rule.

We can agree, then, with the critics of distribution to the extent that the marketing side of business should be carefully scrutinized, perhaps more carefully than it has been in the past. With a view to attaining this end, the techniques of cost analysis can be as profitably applied to distribution as they have been to production. These techniques, as applied to distribution costs, are still in a primitive state, and the end of a healthy expansion of manufacturing will be served by advancing them. This, and efforts directed toward more effective marketing, which will not always be cheaper marketing, would seem to be the policy most consistent with the requirements of an expanding economy.

## PRICE POLICY

A policy which has characterized a number of American industries is to strive for profits through relatively small margins on large volume. This is a practice which is especially consistent with the American methods of mass production and a principle, incidentally, which applies not only to large businesses but to

many specialized concerns which attain large volume on one or a limited number of very small products. The automobile industry, including both the large manufacturers and the smaller plants producing large quantities of specialized goods, has well illustrated this principle and has made possible substantial profits, high wages, low prices, and great volume. Such a policy is put to a severe test during periods of depression, for at such a time there is a very natural tendency to strive for the maintenance of unit profits or at least the avoidance of losses even on low volume. During such a time, there arises criticism of chiselers and price cutters. Understandable as these attitudes and desires may be, it should be recognized that during a depression they are inconsistent with the basic principles of our economy and, as far as public policy and the deliberate policy of private businesses are concerned, should be resisted.

To follow this low-price–large-volume policy frequently requires that large immediate profits be foregone, and some economists believe that it is unrealistic to expect that degree of restraint on the part of individual businessmen. Economists who follow this line of reasoning are concerned with the existence of so-called "administered prices." These are prices which businessmen can determine as a matter of policy. The argument is that we cannot safely leave such important matters to private policy but that we should strive for such a large number of companies and free price competition as will bring about the determination of these matters by the impersonal forces of the market. In the period following World War II, however, we saw that the prices which reacted most promptly and sharply to the inflationary pressures of that time were those which most closely approached the competitive ideal. The companies selling under administered prices, such as the manufacturers of automobiles, steel, and other products, maintained lower prices than the prevailing market would have made possible. The criticism for such price advances as were made should have been tempered more than it was by credit to many for not taking full advantage of market possibilities. This experience suggests that it is not out of the question for American businessmen to include in their formulation of price policy such considerations of general wel-

fare as the avoidance of inflation, the maintenance of the total volume of production and employment, and the general health of the economy.

One is tempted to say that the business leaders of that war period made a better showing than they or their predecessors did in the depression years, but we must remember that it is easier to forego possible profits than to absorb losses. The prospect of a socially desirable price policy of this kind does not, of course, rely upon sheer altruism but upon the recognition by large manufacturers that their own interest is bound up in the maintenance of stable and prosperous conditions for the whole economy. This consideration probably weighs more heavily with large concerns than with small ones, for the reason that the actions of the large firms will have an inevitable and obvious effect upon the whole economic environment, whereas the small firm can console itself that its own policies will have imperceptible effects in any event. In general, then, we can say that, where price is not determined automatically and impersonally for an industry, the policy of enterprisers on this point is—in its effect upon healthy expansion—one of the most important that these men have to formulate.

## REINVESTMENT POLICY

A policy of American corporations which has attracted considerable attention in the last few decades is that involved in the disposition of their earnings. Particularly, this policy involves a question of retaining earnings or distributing them to stockholders in the form of dividends. In the classical theory of a competitive economy, it was presumed that the earnings of companies would be distributed to their owners and that additional capital needs would be met by attracting funds from the outside. In fact, however, a very large part of the earnings of American corporations are not distributed to the stockholders but are retained and reinvested for the expansion of the concern. Admittedly, there are dangers in this policy. The managers of our large corporations who exert considerable influence in such matters have personal interests both of an economic and noneconomic kind in the expansion of their concerns. It may be

argued that if they can utilize earnings for such expansion, they may employ these funds in their own concern even though they might have been used more productively in some other industry or concern. The argument for obtaining funds from the outside is that then the investors will be continually passing judgment on the comparative uses of them and that comparison, plus the competition of firms for funds, will direct the capital resources of the country into the most productive lines. It may thus be argued that by the process of retention of funds for capital expansion, the managers are able to avoid this direct testing by the market. Thus, there might be encouraged a maldistribution of the capital resources of the country. This danger is real, and it is one of the reasons why there should be a good representation of owners in the control of such policies.

But, on the other hand, the test of effective use of earnings provided by the profit rate is always present. It is present as an objective of the concern and also in the very real sense that, if profits are not made, there will be nothing to reinvest; hence, a continued policy of reinvesting unwisely would bring its own end. Nor will this check be deferred until a zero profit rate is reached, for stockholders of profit-making concerns ordinarily will demand and get some dividends. If the rate of return is not above the level required for such dividends, there will be little opportunity to plow back earnings.

The danger of maldirection of capital is further reduced in the case of large multiline companies. In such organizations there is a choice in the reinvestment of funds between several lines and activities, and presumably the central management of such an organization will utilize its best judgment as to the most effective uses for such funds. If it is deemed most advantageous to invest them within the enterprise, such a central administration has the best possible opportunity for securing the facts and passing judgment upon them. In such a large organization, several of the men representing the different divisions may desire to expand the capital investment in their divisions. Requests to do this are laid before the top management, and the conflicting claims are weighed, ordinarily before the decision is made as to the amount to be reinvested and, of

course, as to the particular uses of the funds. Moreover, in such large organizations, other companies may be represented in the ownership, and in any event the board of directors usually includes men who are important owners in other companies. These representatives of other interests will, presumably, always be comparing the use that could be made of funds if they were declared as dividends and distributed by them personally to these other organizations, with the effectiveness of the funds if kept within the original organization.

In one such company, the committee of the board of directors which exercises authority in the matter of withholding of funds and their use in the organization consists of two men who primarily represent the management of the company, one man who represents the interests of another industrial concern which is a part owner in this one, two men who represent an investment banking group, and one who represents another financial group. If a request from a department manager of this company for larger capital investment is granted, there will, of course, be a smaller dividend distribution, which means a withholding of funds from the other concerns directly or indirectly represented or from the great variety of enterprises in which the financial companies mentioned have an interest. Thus, the men who make this decision represent a very large range of industries, and there would seem to be strong incentives for them to use their business judgment for the most effective utilization of the earnings of this corporation. In this case, the weighing of the alternative claims will probably be done more effectively by the directors of the organization than by outside investors, because the directors have more facts available to them and, if the men have been well selected, because their judgment on such matters should be better than that of the unspecialized individual investor. This is a consideration, relative to interlocking directorates, which is often overlooked by the critics of that type of corporate control. Another objection to this policy of withholding part of earnings, which was raised during the depression years, was that the failure to distribute larger sums in dividends reduced the expenditures of stockholders for consumption goods. This criticism seems less justi-

fied, in fact, than the previous one. From the point of view of maintaining employment, the use of funds for capital goods is at least as effective as their use for other purposes. For the objection to be valid, it would have to be presumed that the corporations withheld funds and then made no use of them and, indeed, that their tendency to sluggishness in the use of funds would be greater than that of the stockholders who would have received the dividends. This assumption does not seem to be warranted.

The policy of retaining funds is frequently ascribed specially to large corporations. But it is probably even more pronounced with small family enterprises. It does not attract so much attention in those cases because the owner does not make such a clear distinction between his personal income and that of his little business. Indeed, it has been estimated that, in previous generations when the corporate form was less common, the proportion of earnings retained for capital expansion was greater than it is today. The characteristic way, for example, of developing a farm has always been in the plowing-back of income rather than in the investment of capital in the enterprise from the outside.

On the whole, therefore, a criticism of this policy of American business does not seem to be justified, and especially not as a new phenomenon invented by the corporations. On the contrary, it is an effective way of providing the essential capital for an expanding economy. Although we recognize that the direction of investment under this policy may not be perfectly adjusted to the relative needs of the economy, the effect is still in favor of over-all expansion. It would perhaps be going too far to say that this policy should be definitely encouraged, but it is one which should not be discouraged by public policy, such as discriminatory taxes on undistributed profits. The best direction of it will come from the free decisions of the managers and owners of those enterprises.

## REPLACEMENT POLICY

Another policy that has a bearing upon the rate of expansion is that of replacement of old equipment by new. It has fre-

quently been observed that the readiness with which businessmen will lay the old aside is more pronounced in this country than elsewhere in the world. This aspect of American business policy is explained by a number of considerations, some strictly economic and some rooted in the national character. The tendency is closely related to the rate of technical progress; an important reason for discarding an old machine is that a new one has been invented which is sufficiently better to effect substantial economies in production. But the degree of superiority required to justify the purchase of a new machine is not a fixed ratio. On the contrary, the force of this reason for change will be enhanced when the other factors of production are relatively scarce and costly, and it will be diminished when they are plentiful and cheap. For example, if an expensive machine is invented which will effect a saving of 10 per cent in labor for a given productive task, the response of a manufacturer will be quite different if he is operating in a country or region where wages are low than if he is operating in a region where wages are high. It is clearly more reasonable to economize (i.e., use most effectively) expensive labor than cheap labor. The high wage rates of this country thus favor prompt replacement of equipment. But the chief reason for the high wages is the high productivity, which in turn is largely induced by large amounts of effective capital goods. In this way the extensive use of capital by a country is a cumulative force inducing the use of still more and better capital goods.

Another factor that will force the ready adoption of cost-saving equipment is active competition. If, under competition, one company adopts an improved machine, that act will place pressure upon the other companies to do likewise. The first company may, as a result of its reduced cost, reduce prices; but even if it avoids that direct price competition, it will have more leeway within which it can improve the product, increase advertising, or give better dealer margins or dealer aids. Any of these actions will impel other companies to follow suit. Hence, an explanation of the more prompt replacement of machines in some countries and some industries than in others lies in the degree of competition that prevails in them.

Another consideration often suggested as having a bearing on the rate of replacement is depreciation. Aside from the tax effects, this accounting policy should logically have no effect on the question of replacement. That question should be decided on other grounds, such as those just mentioned. Perhaps there is a psychological effect, based on the reasoning that, if a piece of capital equipment has been completely or largely written off, it has paid for itself. As the popular expression goes: "It doesn't owe you anything." The effect of this psychology is not to be disregarded merely because the reasoning on which it is based is fallacious. When high tax rates are introduced, a more tangible consideration enters the picture. If a low rate of depreciation has been employed, the replacement of old equipment by new can be accompanied by a showing of substantial loss for tax purposes on the abandonment or sale of the old equipment. If, for example, an old machine cost $10,000 and has been depreciated by only $3,000, a loss up to $7,000 can be taken; and at a tax rate of 38 per cent, this represents a tax saving up to $2,660, which may well act as encouragement to replacement. If a higher rate of depreciation had been applied, it is true that tax savings would have been made in the earlier years, but that fact would not so directly affect the decision at the moment of proposed replacement.

In addition to these strictly pecuniary considerations affecting the rate of replacement of equipment, there is also the general attitude of the people. Foreigners have often remarked upon the willingness of people in this country—consumers as well as businessmen—to discard the old in favor of the new. This basic attitude of American people is bound to affect business decisions as well as consumer choices. Its higher development in this country than in others, no doubt, reflects a confidence in the future, perhaps an unusually high degree of social emulation ("keeping up with the Joneses"), a relatively great emphasis upon progress, and a relatively less emphasis on security. It is no doubt enhanced by a high degree of mobility of people, as between geographical areas and social classes. Uncertain as may be the reason for this trait of national character, it is probably one of the most important reasons for the high

rate of change, the rapid rate of progress, and perhaps also the relatively less stable features of our economy.

## CONTROL OF CORPORATIONS

Important among the policies of business which have a bearing upon expansion are those that determine who is to control the business enterprise. It appears that in many of our large corporations the real control rests in the hands of management itself.[2] American practice in this respect differs substantially from British practice. In Great Britain the shareholders are reported to exercise a more direct control over corporation policies. Some observers believe that this fact creates a leaning toward conservatism. A number of social and economic implications of the relative independence of managers in some concerns have already been brought out, but one that should be stressed here is the effect which managerial control of corporations, both large and small, has or is likely to have upon the policies followed by those corporations as regards production and expansion of business.

There are conflicting views on this subject. Some observers whose opinions command respect are particularly impressed by the more conservative attitudes which may be induced by the status of salaried employees as against ownership. One of these observers points out that, in spite of elaborate systems of incentive payments, the position of the hired manager is far removed from the classical method of remunerating business leadership.[3] In that method the reward of leadership was sup-

---

[2] A study by Paul Holden *et al.* on *Top Management Organization and Control* (Stanford, Calif.: Stanford University Press, 1941), p. 220, indicates that of 31 large companies investigated, the typical board of directors was made up as follows: 42 per cent officers, 7 per cent former officers, 19 per cent substantial owners, and 32 per cent outsiders. Thus, in these companies 49 per cent of the directors held their position primarily because of their position in present or past management.

A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New York: Macmillan Co., 1940), p. 94, conclude that, of 200 of the largest corporations, 44 per cent have management control, 23 per cent have control by an individual or group holding a substantial but minority ownership, 5 per cent are controlled by majority ownership, and some 21 per cent are controlled through various legal devices.

A later study by Robert A. Gordon, *Business Leadership in the Large Corporation* (Washington, D.C.: Brookings Institution, 1945), gives further and more detailed estimates.

[3] Gordon, *op. cit.* pp. 296 ff.

posed to be profits, which, of course, linked the businessman's remuneration directly and completely to the financial success or failure of the firm's operations. It is argued that this direct connection of compensation with profits generated the dynamic type of leadership upon which economic progress depends, but in the large corporation of today that ownership interest of managers is frequently slight.

However, observation of business executives suggests that, as between inactive owners and managers, the latter are commonly more inclined to creative policies that will lead to expansion than are the former. There are also a priori reasons previously discussed (Chapter 6) which should be recalled here. The managers would naturally desire to increase the scope of their activities for purely individual and pecuniary reasons, but also, and perhaps more important, from the mere fact that their own sense of importance and prestige are enhanced by the expansion of the enterprise with which they are associated. Furthermore, the managers are in direct day-by-day contact with the more tangible problems of production and marketing. They are keenly aware of their position in competition with other companies and are jealous of maintaining that position, not only for the preservation of the assets of the corporation, but for such "hedonistic" motives as the creative impulse and the speculative impulse and for a sense of accomplishment.

The owner, on the other hand, having less personal and direct contact with the problems of business and, especially in the cases of small stockholders, less pride in the development and progress of the concern, may lean toward more conservative policies designed to protect the investment. This is not to deny that both owners and managers have an interest in maximizing profits, but profits are ordinarily to be attained only by the assumption of risk. The managers, possibly for reasons of temperament, because the venture will be under their control, and for the other reasons mentioned, may give more emphasis to increasing the profits and somewhat less emphasis to conserving established positions and existing capital.

But the nature and the extent of the influence of ownership and managerial interests upon business policies is not clearly

demonstrable. In view of this uncertainty, a number of companies make a deliberate effort to attain a balance by encouraging the executives to become part owners. This may be done by paying executives bonuses in stock of the company or by providing favorable options to the executives for the purchase of such stock. Among the large industries of the country, it is true that in most instances the proportions of stock held by the managers are relatively slight, but that is not the essential test. A very small share of ownership of one of our giant corporations may represent a very important financial interest to the particular manager. One case study of this subject, covering 264 top executives in 149 large corporations, shows that the median holding of stock by those in industrial corporations was about $300,000 and that over one-fifth of the executives had an ownership interest of a million dollars or more. On the other hand, as to the executives in public utilities, the median was $37,000; and in the case of railroads, the median was only $1,200.[4] In other words, in railroads and public utilities the managers are much more clearly in the hired-employee category, while the industrial corporations have gone farther in combining the interests of ownership and management.

The fusing of the interests of ownership and management is likewise encouraged by a balanced representation on the board of directors between those whose interests are purely financial, i.e., ownership; those who have a substantial mixed interest in ownership and in management; and those who are purely managers. All three of these interests can well be represented on the controlling board, and the selection of members and the maintenance of a desired balance are important points of the higher policy of large corporations.

## EXECUTIVE COMPENSATION PLANS

The maintenance of an active and constructive interest in the growth of a company can be influenced by the policies which companies adopt as to promotion and compensation. A considerable number of companies in the United States utilize a bonus plan for their executive officers. Under such a

[4] *Ibid.*

plan, part of the compensation is in a fixed salary; but another, and sometimes a very important, part is dependent upon the profits of the enterprise. The formula is sometimes arranged so that no bonus is paid until the profits of the concern exceed some standard and previously agreed upon rate, but profits earned above that standard rate go in part to an executive bonus fund. This fund is then distributed between the several executives, perhaps again on the basis of a previously arranged formula, or in some instances upon the judgment of a special committee of the board of directors, and between the people below the top levels, on the basis of the judgment of the individual manager of an operating or functional department. If such a plan is deliberately drawn for this purpose, it can have a powerful effect in stimulating competition between the various executives as to the showing their divisions will make compared to others and as to their contribution to the increased volume and earnings of the company as a whole. The two tests of volume and rate of earnings are, of course, different; and if the objective of the company is to maintain or advance its position in the industry, the former, as well as the latter, may be taken into account in the distribution of executive bonuses.

But executive bonus plans are of various kinds and apparently are prompted by a variety of purposes. Some of them have been little more than devices for increasing the compensation of a few high executives. Others have been ingeniously arranged to play upon the motivation of the whole managerial group and thus to combine the driving force that operates upon the small owner-manager with the advantages of the large organization. Therefore, while it is probably impossible to reach the generalization that bonus plans have, in fact, always or generally contributed to the constructive efforts of managers, it seems that such a plan, when properly drawn and administered, can well have that effect. The potentialities of well-conceived and administered plans are, in other words, more important than a generalized conclusion of the value of existing plans.

There is a commonly observed trend in executive compensation toward retirement plans and annuity funds. To some this indicates an increasing interest in security at the expense of more

venturesome attitudes. This conclusion can easily be exaggerated, however, for in recent years the highly progressive personal income tax has, to a substantial extent, destroyed the effectiveness of additional income to those who are already in high brackets. On the other hand, the federal tax system favors the accumulation of retirement funds, and this is an important explanation for this trend.

The maintenance of desired incentives through compensation policies requires, first, that no undue emphasis should be put upon advancement by seniority; second, that the gaps between salary levels should be sufficiently large to make the striving for advancement worth while; and third, that there should be a large enough number of these levels so that nearly everyone in the organization can envisage a rung of the ladder one step ahead and sufficiently attainable to make it a practical objective.

## COMPETITION WITHIN THE ENTERPRISE

The positive force of competition in our system has been noted at several points. It is a force which can be drawn upon within the organization as well as between economic units. There are some companies, particularly among public utilities, which by virtue of their position do not face direct competition with other units to the extent that industrial corporations do. In certain of such organizations an attitude of rivalry is created, in a sense artificially, by frequent comparison of performance of the parts of the organization. The results of this competition may be related to compensation or to advancement, or possibly only to the prestige and power which executives enjoy within the enterprise. An example of the successful effort to maintain a competitive attitude between operating units is provided by the American Telephone and Telegraph Company and its regional divisions.

The effort to maintain such an interdivisional competition when competition between companies is in danger of declining is itself a tribute to the force of rivalry in controlling the actions of people and in bringing forth their best efforts. One is tempted to speculate upon the possibility of maintaining such competi-

tive attitudes in a publicly owned enterprise or in a completely socialist state. If such a state were ruthlessly administered, an approximation to this rivalry would probably be possible. On the other hand, if such a state-owned enterprise were operated in a democracy, it is quite likely that there would be a leveling process as to compensation and an increasing emphasis upon promotion by seniority. If these forces did prevail, the keen rivalry of privately owned business might well be lost. A cursory comparison of some of our larger utilities and the post office system, which are to an approximately equal extent free from outside competition, suggests this possibility.

Another opportunity for the maintenance of this competitive attitude is found in a large organization which produces somewhat unique but still competitive products. It is a matter of common knowledge that the General Motors Corporation encourages this attitude of competition between its operating divisions, many of which appear to be in almost as direct competition with one another as they are with producers outside the corporation. The development and maintenance of such a competitive attitude within the company implies a considerable degree of decentralization of authority and the assignment of responsibility and power to the divisional heads. The maintenance of this attitude of competition and, at the same time, a due interest on the part of all divisions in the over-all success and policies of the corporation requires wise adjustment of general administrative policies. Indeed, the maintenance of such an atmosphere, which creates a nice balance between the forces of individualism and co-operation, is one of the chief tasks of top management in the large enterprise. The problem appears to have been successfully solved in some instances; and where that is accomplished, the tendencies toward bureaucracy which are assumed to threaten the large organization may be avoided.[5]

This competitive attitude in large companies may be further stimulated by an emphasis upon the share of the market which the corporation as a whole or the particular division succeeds in obtaining. It seems to be a general characteristic of industries

[5] For a discussion of this and related subjects cf. P. F. Drucker, *Concept of the Corporation* (New York: John Day Co., 1946).

dominated by a relatively few large producers to place emphasis upon this percentage of the market—at times it seems even more than upon the rate of earnings, although the two are, of course, interrelated.

## EXECUTIVE PERSONNEL

But aside from the ultimate control of corporations, much of their dynamic character will depend upon the characteristics of the executive personnel, including even those who are in relatively minor positions of responsibility. A company can hardly have a more valuable asset than an active and imaginative staff of executives. In view of this fact, so well demonstrated by observation of American corporations, it would seem important to give careful and deliberate attention to the recruitment of imaginative, intelligent, and well-trained young men for future executive positions. The matter is too important to be left entirely to the forces of natural selection from the rank and file of employees. A number of our best-managed companies, even during the depression, continued to scout the universities of the country for promising material. Their attitude was that, even during such difficult times, one could not afford to neglect the seed from which the crops would later be produced. Much more could be learned about the processes of selection, but the point to be emphasized here is that selection of executive personnel should be recognized as one of the major problems of a continuing enterprise and not merely left to chance.

Closely related to the selection of promising material is a policy of promotion from the ranks and the establishment of systematic means of discovering abilities as they are revealed within the organization. While selection of top executives by promotion has obvious incentive value, it is coming to be recognized by some of the largest corporations that the highly specialized nature of the jobs at the lower level militates against the development of that broad grasp of the whole business which is required for general management. A partial answer to this problem of finding "generalists" for the large companies is to recruit men who have shown unusual abilities in smaller companies. A number of the men in positions of highest responsi-

bility in the three largest companies of the automobile industry today were recruited in the earlier days of the industry from the small companies of that day. But today hardly any companies in this industry are small enough to provide future executives with the required experience in all the major business functions. This fact forces upon the large concerns the problem of deliberately shifting men within the organization to give them the experiences which previously they gained in the natural course of duty in small concerns. Incidentally, this is a problem which is more acute for big business than for small and medium-sized business. The problem also suggests the broad interdependence of companies of different size. In our whole economy, we need variety in this respect as in others.

Careful attention needs to be given to these matters in large organizations because in all institutions there is a tendency toward conservatism. Individual leaders grow old both in years and in point of view, and, hence, real effort must be made to maintain the youthful and aggressive qualities of the enterprise. More than a system, however, is needed to accomplish this result. Managers must strive, not to make the young men into likenesses of the old men, but to encourage in the young men the same daring qualities that the old men had when they were young. There is no innate necessity for a corporation to show signs of age with the passing of the years. It can be, not only legally but actually, an ageless organism.

Our conclusion concerning the problems of large enterprises is that, by encouraging an ownership interest among managers, by attaining a good balance of owners and managers on the controlling boards, by a well-conceived compensation plan and executive personnel policy, by the maintenance of a degree of decentralization and a competitive attitude between parts of the enterprise, and by other policies appropriate to the particular industry and concern, it is quite possible to maintain the attitudes of innovation and progress which are essential to an expanding economy.

The fact is that either progressive or excessively conservative qualities are not the exclusive characteristics of large or small business firms. In the past decades, the industries that have been

characteristically operated by large companies have made at least as good a showing as those in which small units prevail. On the other hand, some of the most striking examples of stodgy and unimaginative management are found among the small, family-owned retail stores and manufacturing concerns. The difference lies in the quality of the people involved. But in the large companies, definite business policies are needed to obtain these desired qualities and to preserve the desired attitudes, while in the small concern the personal qualities of the owner permeate the business without the necessity of such conscious policies.

There is a need also for businessmen to take a more conscious and broad interest in the economic problems of the country, and especially a more constructive interest in the relations of government to business. For all businesses, but especially for the larger ones, these matters have become of such great importance that they cannot be regarded as subjects on which opinions can be formed merely from reading the newspapers and hearing discussions. They have become an important part of the problem of management and deserve, in the case of large organizations, special personnel for their study and the time and serious attention of business leaders within, as well as outside, business hours. In other words, these leaders have an interest in political economy in its broadest sense, not merely as citizens but as businessmen.

The direct effect of such an extension of interest upon business expansion is hard to predict, but it should have the effect of bridging that gulf which to some extent exists between the practical businessmen and the theorists, both in government circles and in universities—a result which we can hope would be mutually beneficial.

These points of business policy are illustrative of others that will apply generally or in particular situations and that together will add up to an expansionist bias for American industry. They are interdependent and overlapping. For example, a program of new product development will stimulate a search

for possibilities of expanding sales through better market research and through tapping new levels of the market, which, in turn, points in many cases to a low price policy. All of these forward-looking and venturesome policies will most likely be advanced by energetic and imaginative staffs working under a system of incentives that will encourage their constructive possibilities.

In summary, it appears that in seeking the elements of a favorable climate for business expansion we must include as one of those elements the businessmen themselves and their policies. The environment and the men who operate in it cannot be separated. For an individual businessman, perhaps the most important element of his environment is what other businessmen are doing. Expansion, like stagnation or contraction, is contagious; and it is possible in this sense, and to an unknown extent, for businessmen as a group to lift themselves by their own bootstraps.

# 19

## *THE PRICE LEVEL*

A FREE market system is, in the broad sense, "a contract system." This term implies that in such a system men do business by voluntary agreements: agreements to buy and to sell, to work for another or to employ another, to lend funds or to borrow them, to allow another to use one's property or to engage to use property and pay for its use. There are a number of requirements for the proper functioning of such a system. One, for example, is that men shall act in good faith, that is, with an intention of carrying out their part of the agreement, and that there shall be, for those who act otherwise, legal means of enforcing the contract or otherwise obtaining settlement. But with the best of intentions a contract system cannot work well unless there are commonly accepted, stable, and uniform standards. These standards are necessary to enable men to know precisely what they can expect and what is required of them.

### NEED FOR STANDARDS

Because it is necessary that these standards be generally recognized and accepted, we look to the government either to set them in the first place or to adopt some existing standard, but, in any event, to give its stamp of approval and to maintain the standard throughout its domain and to preserve it from capricious change. We recognize, for example, that, for the conduct of business, standards of weights and measures should be established and maintained. It is the responsibility of the government, and so recognized in the Constitution itself, to establish and maintain these standards. A pound of weight, for example, depends upon the definition set by the government. The meaning of a foot and a yard is set by the length of a certain metallic bar which is carefully preserved in the Bureau of Standards. What we mean by the days of the year is likewise deter-

mined by the government, and the precise time of day is also established and reported generally by the United States Naval Observatory. Thus, the standards by which we measure the tangible things of this world and particularly the things which enter into commerce—weight, linear distance, volume, and time—are set by the government. Moreover, a number of the commodities of commerce and the definitions of certain grades of commodities, such as No. 1, Red Northern wheat, are likewise determined and maintained.

## PRICES AND THE VALUE OF THE DOLLAR

But the most important unit with which the businessman deals is the dollar. The dollar holds this important place because it is the unit in which prices are measured; indeed, a second brief way of characterizing our economy is to call it a "price system." Prices serve the functions of directing production into the most desired lines, of stimulating the total volume of production, of distributing the proceeds of the social product to the various participants in production, and of inducing people to conserve those products which are scarce and to use liberally those products which are plentiful. These functions are performed by *individual* prices, each regarded relative to others: the price of materials, labor, and land relative to those of finished goods; the price of some finished goods relative to others; the price of some materials relative to others; and so on through the intricate network of prices.

Although the significance of prices is in measuring the relative values of goods and services, it is not feasible for various practical reasons to express prices in that way. That would require us to say that a pair of shoes is priced at 3 bushels of wheat, 5 bushels of potatoes, 8 hours of common labor, or 6 hours of skilled labor, and similarly with all other things or services. We solve that problem by having them all measured in terms of one common unit. That is a very ingenious and useful device, but it should not conceal the fact that what we are trying to do is measure potatoes in terms of shoes and other goods and that the dollar is only a device for that end. But if we take that view of money prices, what shall we say when the price of all

goods and services moves upward or downward? Such a price change does not represent changes in the values of things. We must conclude, then, that it represents a change in the value of the monetary unit itself; for example, if we went out some morning and measured a number of unrelated familiar things and found them all an inch longer than they were the day before, we would conclude that something had happened to our yardstick. Hence we describe a general rise or fall of prices as a change in the value of the dollar.

But while the analogy of the dollar as a yardstick of value is useful, it is not perfect; there is one difference which makes it much more difficult to maintain a standard value of a dollar than to maintain a standard length of a yardstick. That difference is that the yardstick exists separately and independently of the things which it measures. But the value of a dollar has to be expressed in terms of the very things which it is supposed to measure. True, the dollar can be defined in terms of so many grains of gold, but that merely shifts the logical problem back to the relation of gold to other things. The difficulty is reasonably overcome, however, when we consider that the function of the dollar is to measure the values of particular things, while its own value can be measured in terms of things in general. A composite index number made up of the prices of a large number of representative things will serve the purpose. The problem of defining the value of the dollar, at least closely enough to tell whether it is shrinking or stretching from year to year, is thus not beyond solution. But clearly we cannot hope for the same degree of stability as in our other units. Therefore, in the suggestion that we should desire a "stable dollar," that term must be taken in a relative sense. To strive for a perfectly unchanging price level would be futile, and the efforts to reach it might do more harm than good. But the fluctuations of the last two or three decades have been so wide, when judged by any reasonable standard of stability, as to indicate that there is much room for improvement.

## EFFECTS OF CHANGING STANDARD OF VALUE

Since we have said that the function of the standard monetary unit of value is really not to measure the value of things in

terms of that unit but rather to measure the values of goods and services relative to one another, the question arises: Why should we be concerned with changes in the value of the dollar itself? If it were true that, when the general level of prices went up (the value of the dollar shrank), all prices, wages, and incomes moved together, the implied objection would be well taken. It would make no difference if the component elements of a thing were \$1.00 or \$2.00 if the finished product were correspondingly priced at \$1.10 or \$2.20 and if the prices of all other goods and consumers incomes were also correspondingly adjusted.

But these conditions can obviously never be attained. The prices of some goods and services go up more rapidly than do others. Thus a shift in the price level itself creates maladjustments in the relative prices. For example, the incomes of some people, such as civil service employees, members of the armed forces, clergymen, schoolteachers, college professors, and all living on pensions or on the proceeds of annuity or life insurance policies, will move slowly, while the price of sensitive food products, like butter and eggs, will move quickly. The wages of day labor will be more flexible than the wages of several groups in the skilled labor class. The prices of some raw materials may move faster than the prices of their finished products.

In some other instances the opposite relation may hold. Rewards and penalties based upon such chance factors serve no useful purpose and create a great deal of confusion and hardship. Furthermore, they have the very practical effect of radically shifting the purchasing power of various groups in the community. This should not be taken as an objection to changes in relative prices which are caused by changing demands for the several goods and services or to the changing supply of those goods and services. Price changes of that kind serve a good social purpose, but no good purpose is served by changes in the relative positions of people in the community created by the shift in the price level itself. One of the bad features of a changing price level is, therefore, in the different effects which it has on specific prices arising out of the "stickiness" or flexibility of those prices.

Another important area in which a changing price level is

significant is the position of savers and investors. The effects of an unstable dollar can be viewed from two angles, namely, from the position of those who save money and thus provide the basis for capital formation, and from that of those who utilize those funds and thus perform the other part of capital formation. Looking first at the savers, if there is a prospect or a substantial possibility that the price level may rise between the time of saving and the time of use of the savings, that will cause a loss to the savers which they will feel is unjustified and capricious. For while the people or institutions to whom they lend their money may scrupulously live up to the contract which requires the repayment of a specified number of dollars, those dollars may be quite inadequate to meet the needs for which they thought they had provided. The inequity of a shift of this kind seems apparent. It affects older people, dependents who have been provided for by insurance policies, holders of government bonds who were urged in time of national emergency to lend their purchasing power in return for security at a later time, and, in these later days, millions of people who are involved in our social security program. There is no need to labor the inequity to these classes of people.

But even applying the pragmatic test, i.e., the effect upon general economic well-being, one cannot disregard the loss of national unity which would be induced by this feeling of injustice. Moreover, if it is generally observed that savings do not bring forth their desired reward and if this conclusion permeates the thinking of the whole community, it would be expected to have discouraging effects upon the amount of saving. In recent decades it has become the fashion among economists to be more concerned about the use of savings than about the making of them. It is true that there are times when the use of savings seems to be our current problem; but it should not be overlooked that, when we are dealing with such long-run secular movements as are involved in capital formation and the effects of these movements upon the growth and decline of nations, the amount of savings which individuals are willing to make is fully as important as the willingness on the part of enterprisers to utilize those savings. The feeling that it is wise to put some-

thing aside now for the "rainy day" is firmly grounded among our people, but there is no assurance that that feeling would withstand the effect of a long continued period in which plans and ambitions are frustrated.

It should be remarked that for the frustration of these hopes it is not necessary that there should be any sudden rise of prices such as is commonly associated with the term "inflation." An advance of even 2 per cent a year, for example, for a period of twenty years would mean an increase of nearly 50 per cent in the price level; this would mean that, for every $1,000 worth of purchasing power saved by an individual in the earlier period, he would receive approximately two-thirds of that amount at the later period, disregarding possible interest accumulations, on the one side, or losses through total or partial failure of the borrowers to live up to their obligations, on the other.

On the other hand, the borrowers of funds, including the enterprisers who wish to put them to use, would be encouraged by the prospect of rising prices. In the short run, goods which are bought today can, assuming business judgment to be sound, be sold at a later time at higher prices. In the long run, the enterpriser who is contemplating the building of a plant today which will yield its products over the years to come will be encouraged by the prospect that the price level at the time of sale of his goods will be higher than at the time he built his plant. Likewise, borrowers generally, including the federal and local governments, will be encouraged to borrow by the prospect that at the time of repayment, price levels, income levels, and all revenues in terms of dollars will be higher than they are at the present. Thus, one can say that, as far as the first and perhaps superficial effect is concerned, a rising price level encourages the employment of funds but discourages the accumulation of funds.

If we consider the prospect of declining prices, the relations are reversed. The savers will be encouraged by the fact that the dollars saved now will have higher purchasing power than when they are repaid. But a declining price level will have a correspondingly depressive effect upon the enterprisers and borrowers generally. The enterpriser, in this case, must anticipate that the general price level is going to move adversely to his interests;

and he would, therefore, naturally confine himself to such commitments as give promise of sufficiently large rewards in dollar terms to offset this trend. This means, of course, that many of the marginal and less promising developments which are needed to maintain a dynamic economy would not take place.

All this, however, is an oversimplified version, for the estimation which both borrowers and lenders will make as to the future of prices will be recognized by them as containing a high degree of uncertainty; and uncertainty itself is a deterring factor. In other words, if an enterpriser considers prices highly unstable and the future very much in doubt, he may hesitate to make commitments, even though he believes that prospects of prices advancing are about as good as of prices declining. The prospects do not completely cancel one another, because uncertainty is regarded as a disadvantage in itself. The same observation can be made concerning savers if they feel that the future is extremely uncertain, for then the possibility that the price level will move downward (in their favor) is not completely offset by even an equal prospect that it may move upward. The result of this feeling of uncertainty, as to the standard of value in which economic transactions have to take place, is, therefore, to act as a deterrent both upon the supply of funds and the demand for them.

Moreover, everyone recognizes—and businessmen particularly—that a rise of prices, especially if pronounced and rapid, is likely to be followed by a drop in prices. This perhaps does not materially affect short-time commitments, such as buying goods for retail inventory; but it is likely to affect decisions on long-time commitments, such as expanding of plant and equipment. The corresponding observations could be made with a change in terms for the savers. The prospect presented during a period of rising prices is ordinarily not that of continually rising prices, but rather the prospect of a rise for some period of time and a drop to unknown levels at a later undetermined time. It is sometimes said that a gradual and continuing rise in the price level is stimulating to business. This is perhaps true; but conservative businessmen, who have learned

from their own past experience and from that of their predecessors that a reversal of trend at some future date is more likely than a continuing steady advance, will take those facts into account; and the continually stimulating effect of an ever rising price level is, therefore, not likely to be realized in actual life.

We have considered the problem so far from the point of view of one country by itself. In fact, however, funds can and do flow from one country to another; and a prospect of rising prices, especially of the extreme upward swing of inflation, may well lead the investors of that country to withdraw their funds and to seek another country in which those prospects are not so pronounced. This phenomenon, known as the "flight of capital," has taken place in those European countries which have experienced inflationary movements or prospects. It is like the depressive effect upon savings except that the former can take place in a very short period and the latter usually works itself out over a longer period of time.

Another effect of rising prices and the prospect thereof is to encourage enterprisers to obtain funds for expansion by borrowing rather than by the sale of stock, that is, by debt capital instead of equity capital. This tendency is undesirable, as a general rule, and at any rate it can easily be carried too far. The accumulation of debt by companies tends to put them in a vulnerable position because they are subject to the legal obligation of having to make interest payments and ultimate repayment of the principal. The possibility of making these payments would, of course, be impaired either by normal vicissitudes of the business or by a downward turn in the price level. This is not a complete condemnation of that method of financing; but at best we can say that the decision as to whether to provide capital by borrowing or by increased owner interest should be made upon normal business considerations and ought not to be accentuated by movements in the value of the dollar.

Since an essential part of business activity is the assumption of risk, why should we be concerned that the risk of change in these physical and value standards should be removed? Basically, the reason is that risk, for most people, is a negative incentive, and the greater the risk, the greater the deterrent to business

commitments. Moreover, in any kind of business commitment there will be a considerable element of risk which will remain, even if all of the basic terms have been standardized. For example, an enterpriser builds a plant to produce a certain kind of textile. There is the question of the demand of the community, in which he is selling, for textiles in general and the demand for the specific kind of textile which he is preparing to produce. There is the uncertainty as to how many other manufacturers will attempt to produce the same product and uncertainties as to the supply of material and other productive resources and the specific cost of them. But there is a limit to the amount of uncertainty that a business enterpriser will assume relative to the prospects of reward, in the event of success, and of loss, in the event of failure. If, then, and to the extent that it is necessary for him to assume risks as to the standards themselves, the enterpriser will be less willing to accept the other risks, and thus the expansion of economic activity will be checked.

A general statement, then, of the reasons for desiring a relative stability in the value of the dollar is that our economy is directed by rewards and penalties. A special task of the business enterpriser, and one of the chief justifications for his existence, is to determine to his own satisfaction the probable trend in the demand for specific commodities and the costs and difficulties of producing them. As an incentive to make right decisions, our system imposes penalties for errors and provides rewards for good judgements. But there will always be contingencies that transcend intelligent forecast: they include, for example, natural disasters and wars, as well as price-level changes. Clearly these should be reduced to a minimum, or at least not increased by human agencies; for in so far as they dominate the scene, penalties and rewards will be of the capricious windfall variety which serve no good social function.

More specifically, from the point of view of this study, which takes as an objective a continuously expanding economy and which relies for its means so largely upon the decisions of business enterprisers, the level of prices holds a key position. When we speak of the businessman's confidence in the future, certainly one of the important elements we must have in mind is his con-

fidence that dollar transactions which extend over a period of time will be completed with dollars which will bear some resemblance to those involved at the beginning of the transaction.

## INDIVIDUAL PRICES AND THE PRICE LEVEL

From what has been said, it is perhaps clear that the need for a stable price level does not imply a need for stable prices of particular things and services. But the distinction should be stressed. The functions of prices are performed by changes in prices. Such price changes serve to shift productive effort from relatively plentiful goods to relatively scarce goods, to provide a pervasive pressure for conserving scarce goods, and in general to direct the economy according to the will of the consumers in the light of existing resources. Since changes in demand and supply situations are registered by price changes, and since such changes in demand and supply are inevitable in a dynamic economy, it is evident that individual prices should be left flexible. Indeed, the main reason we desire a stable level of prices is that variations in individual prices will be better able to perform their functions.

To this general statement of the need for free-moving prices, there are some exceptions, but these are more apparent than real. For example, during wartime we may feel that, we cannot afford to let the people *as consumers* direct the production and consumption of the country, but rather that the will of people collectively *as citizens* must prevail. At such times, therefore, we may place radical limitations upon the functioning of the free price system. Likewise, the community may conclude that the prices of some classes of goods—for example, agricultural products—should be supported on grounds that override the economic desires of the people. In this decision, political pressure groups are usually decisive. These and other cases are instances in which the government, for good or bad reasons, does not wish the ordinary economic motives of consumers to prevail. These cases, therefore, are not true exceptions to the rule that translation of the dictates of the market into action requires free-moving individual prices. A control of the price level, if it is not to defeat its own end, must be accomplished by such general forces and

pressures as will influence the level of prices without regulating or fixing specific prices.

## RESPONSIBILITY OF GOVERNMENT

Upon whom does the responsibility rest for the avoidance of inflationary excesses and the maintenance of a relatively stable general price level? The general philosophy expressed in this study has been to rely for the attainment of desired social ends to the maximum possible extent upon those spontaneous forces that arise from individuals intelligently seeking interests that appeal to them as individuals. But reliance can only be placed upon those individualistic forces when certain larger features of the environment are established by the community as a whole. In other words, the doctrine of liberalism just enunciated does not imply anarchy or even laissez faire. It is rather a philosophy of individuals working out their own salvation *within an environment* which, to an important degree, is set by the society. The activities of individuals will best contribute to the general welfare if that environment is reasonably stable. One of the important features of such an environment is the standard of value.

The necessity of the government playing an important role can be seen more specifically if we observe that price trends, in general, are not self-corrective. If the price of any one article starts to rise, there are powerful forces that tend to bring the price back into line. One of these is that consumers will reduce their demands for the product, and another is that the producers will seek to increase the supply in order to take advantage of the advancing prices. Thus, individual price maladjustments are subject to a strong self-corrective force. Prices in general, on the contrary, do not seem to be checked in this way—at least not promptly enough to avoid very serious consequences—and the corrections are likely to be unpredictable and erratic. Indeed, there are times in which prices seem to advance merely because they are advancing and have been advancing; and on the other hand, a price decline is stimulated by the very fact of declining prices in general. Moreover, some of the forces that in earlier days helped to check wide variations have in recent years been

seriously weakened by abandonment of the gold standard, obstructions to the international flow of funds, and other devices. This is equivalent to saying that the general price level does not effectively control itself and, therefore, that we cannot afford to leave it to the combined forces of the market as we ordinarily can do with the prices of individual products.

Another reason why the government must assume a responsibility for the price level is that, in the nature of the case, its actions are bound to be important factors in determining the price level whether it so desires or not. This inevitable effect of government actions upon prices is particularly pronounced during and following great wars. But at any time when the government spends more than it takes from its citizens during a particular period of time, or when it spends less than it takes from its citizens—for example, when repaying a debt—government inevitably has an effect upon the supply of currency and the rate of its flow. So it is futile to ask whether the government should influence the price level, for the answer is that government will inevitably do so. The only question remains whether government will act with a conscious regard for its actions and whether it will so direct them as to stabilize the price level and thus provide a currency in which the people can have confidence and on which they can afford to make their transactions, or whether its actions will accentuate variations and further impair confidence.

Since the fiscal-monetary policies of government are bound to have some effect upon the price level, it seems clear that, when government activities and expenses increase relative to the total national income, the effect of government actions will correspondingly increase. A few decades ago, and even more, a hundred years ago, the role of the federal government, was, both in functions performed and in terms of expenditures, relatively slight. But in recent years its range of activities has tremendously increased; and in addition to these current activities, there is the servicing of the national debt which at the present moment is in the neighborhood of $250 billion, having risen from around $20 billion in the late 1920's. Therefore, any decisions which the government may make, relative to the ag-

gregate burden of taxation, the form of taxation, the repayment of debt, or the buying and selling of its own securities, all have a multiplied effect. If a number of persons are in a crowded lifeboat, it may not be too important if a small child acts irresponsibly in shifting his weight about, but the actions of the heaviest member of the boatload of people becomes a matter of great concern. In this respect our government has become a very corpulent person indeed. Its effect, either for stabilizing the boat or for dangerously rocking it, is correspondingly great.

## INFLATION

When the general price level rises very rapidly, we call the situation "inflation." Suggestions have been made for drawing a sharp line between a rising price level and inflation; but the view taken here is that no such distinct line can be drawn, and we define "inflation" simply as a relatively rapid and general advance in the price level. Whatever may have been the underlying causes, the immediate cause of such a rapidly rising price level is an excessive number of dollars seeking to purchase goods and services. In an expressive, if not elegant, definition, inflation is caused by dollars chasing goods; or in other words, inflation arises from a demand expressed in dollars for goods in general that is substantially in excess of the amount of goods available at existing prices. Since prices tend to equate demand and supply, the effect of this excessive demand is to raise prices.

There are periods in which the amount of purchasing power being bid against the supply of goods will not have the effect of raising prices, at least not rapidly. Such a situation exists when a country is employing its resources at a level well below capacity. Under these conditions the additional active purchasing power may merely have the effect of putting idle resources and men to work, and the effect upon prices would be slight. But as a country proceeds along that line and draws close to a condition of full employment, additional dollars spent are less successful in bringing forth corresponding increases in production, and, hence, the effect may be felt in a sharply rising price level.

This type of situation is especially likely to be found in wartime. At such a time the needs of the government are greatly

expanded; and these requirements, added to the normal civilian requirement, will lead to a complete use of resources. The government may then attempt to meet its ever growing needs for war supplies by coming into the market as an additional bidder for goods with additional dollars of purchasing power, and the result will likely be the sharp upturn of prices that normally accompanies any attempt to buy goods from the market beyond its capacity to produce. Such a result is not theoretically inevitable, as will presently be argued, but there are serious political and social obstacles to the carrying-out of an alternative program, which would avoid these results. The important point is that, during wartime, governments, for political reasons, if not for others, do increase the effective currency; and this fact leads to rapidly rising prices either in the war period or in the postwar period, as has been shown by all of the great wars in which this country has been engaged.

The pressure of dollars seeking to buy goods will depend to a considerable extent upon the tendency of the people, including the business enterprisers, to spend or to save. We here use the terms "spending" and "saving" in their everyday sense: the former means using purchasing power now for goods and services, while the latter means deferring the demand for goods and services to a later time. We do not need to distinguish between the activities of business enterprisers and individuals. In either case, saving, in this sense, involves accumulating cash balances, that is, seeking and holding dollars instead of goods. In other words, saving makes a demand for dollars or their equivalent instead of a demand for goods. Since the inflationary pressure is caused by dollars pursuing goods, if we can reverse the current in this way so that the goods and services will pursue dollars, we would tend to reduce the inflationary pressure.

For our present purpose we do not need to distinguish between the demand for consumer goods and for producer goods—a distinction which is important in some other connections—because the present problem relates to the relation of dollars and goods and the kind of goods does not immediately matter. It is true that if the demand is for producer goods, then *in the long run* the resulting increase in capital equipment would be expected to increase the supply of all goods and thus to ease the

inflationary pressure. But the immediate effect is otherwise, and that means that during a period of inflation or threatened inflation one can have excessive capital expansion as well as excessive demand for consumer goods. This distinction between the long run and the short run poses some disturbing problems. In the postwar period, for example, the supply of some kinds of goods was kept down by a shortage of steel production, and thus the upward price pressure was accentuated. The long-time solution might have been to increase steel capacity, but an effort to do that rapidly would have contributed, at the moment, to a general rise in prices, just as truly as would the demand for consumer goods.

Several of the evils of a changing price level which have been mentioned apply with even greater force to inflation. Everyone seems to agree that inflation of the uncontrolled type which raged in Germany after World War I and in China and certain eastern European states after World War II is deplorable. Radical injustice is done to people who have placed their faith in the currency of the country, and lifetime savings are wiped out. It is true, on the other hand, that there are some people in the community who can profit from fishing in such troubled waters. We have noted before the injustice done to several groups and the unwarranted gains given to others. But in addition to the ethical question the very practical effect is that large classes of people are forced out of the market, or at least must greatly reduce their purchases. The mass-production industries of the United States cannot make up, in sales to wholesale and retail merchants, commodity speculators, and others who gain in such a period, for the loss of markets to the large mass of people who lose. Consequently, a wave of inflation will tend to breed an economic reaction through a shrinking of purchasing power of important classes in the community. Inflation, therefore, is bad in itself in the inequities which are caused, and it is bad, further, because of the unbalanced purchasing power which it creates.

## POLICIES OF GOVERNMENT

Since rising prices and inflation are simply different degrees of the same thing, we can consider the policies of the govern-

ment toward inflation and bear in mind that more moderate use of the same devices can be employed for holding in check a less serious, but still undesirable, price trend. We inquire, therefore, what the government can be expected to do relative to inflation?

One of the most important things that government can do about inflation is to avoid those policies which create it. This is perhaps not a very helpful suggestion after the inflation has actually gotten under way, but it is one that should be borne in mind for the long-run policy of government. The government has a responsibility for maintaining a standard unit of value, or to put it in another way, for avoiding frequent and irresponsible changes in that unit itself. Thus the dollar is defined as equal to—and at one time it was freely exchangeable with—a certain number of grains of gold. Quite clearly, any uncertainty about this basic definition of the dollar would be a disturbing factor, and devaluation of the dollar, other things being equal, would have the effect of causing a rise in prices. Dollar devaluation has not always had this effect, however, because the other things are not necessarily equal—that is to say, there may be a definite trend toward downward prices which will be only offset by devaluation of the dollar. In many, although not in all, of the experiences with inflation the underlying cause can be traced to unsound government financing of a war. Such a great national effort creates very large and new needs of government that impinge upon practically all parts of the productive system. These requirements are in addition to the usual civilian requirements. If the country has been working close to capacity before the war, an excessive demand will develop at once; and, even if the economy had considerable leeway in the form of unemployed labor and resources, a modern war will quickly absorb that margin. It seems quite evident that, if a country aims to supply its war needs without greatly advancing prices, it must reduce the effective demands of consumers for ordinary products and services in something like the proportion represented by its war demands.

How can that be done? One device is to levy such heavy taxes upon consumers that they will be forced to reduce their demands upon the market. Such taxes would have to be very heavy. More-

over, if they are to accomplish their purpose, they would have to impinge upon the masses of consumers, not merely upon the rich. To the extent that such taxes were levied, the effect would be to transfer the purchasing power of the community from citizens to the government. But taxes of this kind and amount are never popular; and, especially in a democracy, but to some extent in all countries, there is a desire at such times to avoid political opposition and to maintain popular morale.

Another device for transferring purchasing power is to sell the people bonds in such denominations and of such types as will reduce the dollars available for consumption and credit expansion. But this device, too, has its limits in the extent to which citizens will voluntarily restrict their consumption.

These practical political objections can be avoided if the government uses its power to increase currency, either by direct printing of money or, if there are deeply rooted popular prejudices against that device, by borrowing from the banking system, which accomplishes much the same result by less shocking means. In either event the result is not a simple transfer of purchasing power but an addition to it. In fact, a transfer *is* indirectly effected by diluting consumer purchasing power; but this means raising prices and has the added bad effect that the government's purchasing power is also diluted, thus increasing the dollar cost of the war. In an effort to resist the upward trend of prices, other devices then have to be employed, such as direct price controls, allocations of materials, direction of the labor force, and rationing of consumer goods—the need for which is greatly aggravated, although surely not entirely created, by the apparently easy method of war finance.

Such a program of inflating the currency apparently places a lighter burden upon the country than would heavier taxation. But that advantage is more apparent than real. Somehow, the people of the country have to pay for the war at the time of the war. This will be clear if we think in terms of things and services rather than money. It is not possible for the human energy of a later generation to produce the shells and airplanes needed now any more than it is possible for one's grandchildren to fight the present-day battles. A war must be paid for as it is fought.

An elaborate system of government borrowing imposes the burdens in less obvious ways and distributes the sacrifices in a particular way. This distribution of burden can then be redressed or compensated for, in a sense, by requiring some citizens (or their heirs) at a later time to pay as taxpayers to other citizens (or their heirs) as bondholders. That, however, merely means that a distribution of income is made in one generation to offset the differences in contributions made by people in the war generation. If taxes had been levied in the war period on an equitable basis (however that might be defined according to the standards of the community), the burden would have been no greater, and the problems created by large additions to the purchasing power of the community and by the later transfer from taxpayers to bondholders would have been avoided.

It should be said in concluding these critical remarks on government war finance, as it is said about many other aspects of public policy, that our shortcomings are not so much to be attributed to lack of understanding by those in authority or to their perverseness as to the fact that in our democratic form of government the experts cannot go far beyond the understanding of the people and their willingness to submit to burdens. The successful functioning of a free political and economic system thus requires a degree of economic literacy on the part of the people generally and especially on the part of business leaders, labor leaders, and other opinion makers.

But if we are faced by an actual condition of rapidly rising prices, we must then consider remedial measures. Here we may recall our diagnosis of inflation as being caused by an excessive pursuit of goods by dollars. If that is a correct statement of the nature of the malady, then it seems clear that remedies must be sought in such policies as will (1) reduce the number of dollars, (2) dampen dollars' propensity to chase goods, or (3) increase the goods pursued—or a combination of these. As to the first, the government can influence, even if it cannot completely control, the quantity of money. As to the second, it is not easy to influence the desires of people to use their money in pursuit of goods, although some influence may be exerted by affecting the distribution of disposable income toward those who will save

it and away from those who will spend it. As to the third, the attack is also difficult, for during such a period productive factors are ordinarily used to capacity. However, even on this point, some influence can be exerted. In several of the specific suggestions to follow, more than one of these objectives will be involved.

The first method to be mentioned, and one of the most obvious ones, for combating actual or incipient inflation is for the government to reduce the active supply of money by levying taxes which will withdraw purchasing power from the citizens in excess of the amount spent by the government for the purchase of goods and services, and by using the government surplus thus created to retire government debt—particularly those forms of government debt which provide the basis for an expansion of bank credit. It will be seen that this policy has three aspects, namely, taxation, government expenditures, and debt repayment. The fact that it is a three-sided policy should be borne in mind, for it is the relation between these three aspects that would create the anti-inflationary effect. Thus the revenues collected by taxes must, if the policy is to be effective, exceed the government expenditures, and the surplus must be used to reduce the effective supply of money.

In an earlier day, when the currency consisted merely of money issued by the government, the debt repayment part of the policy could have been effected by merely using the surplus to retire, that is, destroy, the part of the currency represented by the government's promise to pay. To accomplish the same result today is not quite so simple because the currency consists so largely of bank credit. Nevertheless, the use of funds to retire government debt owed to the banks may have the effect of restricting the supply of bank currency which constitutes a very important part of our money supply. Thus in a less direct way it accomplishes the same results accomplished earlier by the retirement of the government's circulating notes. The distinction between different kinds of government debt must be observed, for the repayment of debt to individuals would place currently usable funds in their hands and thus have the opposite effect from that desired.

Likewise, the kind of taxes and the persons upon whom they bear is also important. To have the desired effect, they must quite evidently be levied upon those persons who would otherwise spend the money. The proportion of individual incomes which is spent and saved varies considerably among economic groups, depending upon the amount of those incomes. The proportion of incomes saved by persons in the higher income groups is apparently larger than that of the incomes of people in the smaller income groups. Since a policy of combating inflation should be one of reducing the number of dollars demanding goods, it would seem clear that a tax policy at such times should be aimed at taking from the people dollars which would be preponderantly spent and using that revenue to retire those forms of debt which provide the basis for active purchasing power. An economically sound tax policy to combat rising prices, therefore, should be one that would collect relatively more from the middle and lower income groups than at other times. To anticipate our later discussion of deflation, it should be noted that this policy is the opposite of the tax policy which would be appropriate during a time of declining prices and depressed trade.

For the government, in a time of rising prices, to collect revenues in excess of its current expenditures does not ordinarily require an increase in tax rates, for with higher prices and incomes the revenues of government will increase even with the old rates. What is needed, then, is merely resistance to the popular pressure to reduce taxes. That pressure will be strong. Indeed, the desire for tax reduction is always strong, and in our view, fortunately so. During a time of rising prices, the arguments will be, first, that the government can "afford" to reduce taxes (as indeed it can if only current financial needs are considered) and, second, that the rising prices are making it more difficult for some classes to "make ends meet" and that tax relief would be very welcome. It is apparent that the suggested tax program for combating inflation will not be popular. In the first place, it collects funds beyond the *current* needs of government, and, in the second place, it cuts into the incomes of the lower and middle economic groups, who, of course, constitute the politi-

cal majority. To this there are two replies: first, inflation is a serious malady, and there is no pleasant remedy for it; and, second, the proposal is an economic prescription for an economic ill; it is not suggested as a political platform which will insure a congressman's election to office.

The desirability of levying taxes beyond the expenditure needs of government is questioned by many people. On the other hand, there are those who would favor such use of the taxing power because of its effect on the level of prices, even if it gave the government more funds than it needed. But at the present and for a long time in the future, that is not a real problem, if we include in the needs of government the repayment of its debt. Even with a high degree of government economy and with the highest feasible tax collections, the surplus would be small compared to the unprecedented large debt of the postwar years. At the time of writing, for example, a surplus for the year 1948 is estimated at some $7 billion. But even this sum does not appear large when compared to a debt of some $250 billion.

In the interest of stability of economic activity, as well as of the price level, it seems reasonable to maintain tax rates in a time of rising prices even though it does mean substantial current surpluses. The argument for this policy can be based on the fact that reduction of the government debt can best be made then, first, because the community can best afford the burden at that time, and, second, because of the direct effect of taxes on the price level. The two reasons are not simply different versions of the same point because the latter might well exist even if the government had no substantial debt. The evident corollary of this policy is that the tax rate should also be maintained during a time of declining prices and low business activity, that is, it should not be raised at such a time, even though the revenues fall short of current government needs. What is conceived, then, is a policy of a stable tax rate through good times and bad, the large revenues of the good times being used to repay the debt and the deficient tax revenues in the bad times being supplemented by deficit financing, that is, the incurring of debt.

The defense of the suggested policy would perhaps be more

clear if we consider the depression and low price period. At such a time, government expenditures in excess of ordinary government revenues will not only be required for performing the ordinary functions of government, but can also be commended as a compensatory policy. There will be plenty of supporters for this latter point of view. We do not condemn this view, but if the policy is to be consistent over the whole cycle, it should balance rapid retirement of debt in good years against incurrence of debt in bad years. A two-sided policy of this kind can be supported both on the ordinary grounds of financial prudence and on the ground of its effect on the price level, supporting it when support is needed and checking it when retraint is needed.

In the postwar period, which was one of rapidly rising prices, there was a considerable movement for tax reduction. The popular support for such a movement was not at all mysterious, for tax burdens were high and taxpayers generally desired relief. Such support as the program had, however, on the part of economists, requires some explanation. One such explanation really falls outside the field of economic analysis, namely, that the most important requirement was to reduce government expenditures and that, as a matter of practical politics, the only way to reduce government expenditures was to reduce government income because the spending proclivities of the government are so great that the only way to hold them in check is to reduce the funds available. On the other hand, many who favored the maintenance of tax rates argued that we should both reduce the government expenditures and gladly accept the increased government revenues which existing tax rates would yield, using the difference to effect a more rapid reduction of the government debt. One who favored this policy could only say that, from an economic point of view, this is what should be done. That it is politically difficult cannot be denied.

The maintenance of existing tax levels does not necessarily mean that there should be no changes in detail. It may well be that there are long-standing, needed reforms as, for example, the reduction or elimination of the double tax on corporate earnings

which, we have argued, is an important need of an expanding economy. If the opportunity presents itself politically for introducing this or other reforms, it should perhaps be seized, although one must admit that the need for such reforms is then less pressing than at a time when business is in a depressed state. Here we have a general political problem of a democracy, namely, that it is politically most feasible to introduce reforms at times when they are least needed or when economically we can least afford them. This holds equally for reforms favorable to enterprise as well as social reforms which may have a depressive effect upon enterprise. The problem of how to deal with that perverse feature of our free system does not seem to be subject to answer on the basis of generalized principles. It must depend upon the conditions, political and economic, that characterize the particular situation.

The second mode of attack upon the problem of inflation is for the government to borrow money at such a time from the people and thereby reduce the pressure of attempted expenditures for the relatively inadequate supply of goods and services. Such borrowing should evidently be from the middle and lower income groups if it is to accomplish its purpose, and the bonds issued should not be of such type as will provide a basis for expanded purchases. The Class E war bonds issued during World War II to small investors (being nontransferable and providing for interest payment only at maturity) would seem to be a type that would meet these requirements. Funds secured by such borrowing can well be employed to retire the other types of bonds which do provide a basis for general credit expansion. A program of this kind can well employ such devices as voluntary payroll deductions. Incidentally, if the whole anti-inflation program, of which this is a part, succeeds, the bond purchases will be advantageous to the buyers because the dollar purchasing power at the time of repayment should be larger than at the time of purchase. Even if we assume that the funds will be spent at the time of repayment, they may well serve at that time to support a market which needs such support. In short, such bonds have the effect of withdrawing purchasing power from current use at the time

they are sold and transferring the active purchasing power to the time of their repayment.

A third policy to help curb inflation is to encourage saving by corporations, a policy comparable to the encouragement of savings just referred to for individuals. At least a negative contribution can be made to this end by permitting corporations to withhold earnings without tax penalty or the threat of such penalty. The distribution of corporate earnings as dividends to stockholders might have the result of increasing the savings of those stockholders, but surely to some extent those dividends would be spent and thus would contribute to the upward pressure upon prices. The opposite pressure would be created if the corporation withheld the earnings and kept them in the form of larger cash reserves. To the extent, of course, that the corporation immediately used these funds for expansion of plant, this deflationary effect would not be realized. During a period of rising prices, however, there is a tendency for enterprises to carry larger cash reserves; and we can, therefore, expect that at least some funds withheld from distribution would be used in that way.

A fourth method by which the government may check an advance in prices and, in its reverse use, check a decline in prices is the open market operations of the Federal Reserve System. Assuming the existence of a substantial government debt, the Federal Reserve banks can reduce the purchasing power of the community by selling government bonds on the open market. This procedure withdraws dollars from the public and from their banks, thereby reducing the reserves of the latter. The reverse policy, to support a sagging price level, is for the Federal Reserve banks to buy bonds, using their own credit to pay for them, thus adding to the money supply which flows to the banks and increases their reserves. These increased bank reserves provide the basis for a general extension of credit. This method has limited usefulness because it is not very effective when the bank reserves are already large relative to demands for credit. At such a time the increasing of reserves will have little effect on the extension of credit nor will the lowering of them cause a restriction of credit. The control of price trends

by this device is most effective at a time when excess reserves are low, i.e., when credit is tight.

A fifth part of an anti-inflation program is for the government to use other methods to restrict the volume of bank credit, for such bank credit provides a large part of the effective currency of the country. One such way, applicable at some times, is to advance the reserve requirements of the banks. These are under legal control and if the percentage of reserve required is advanced, that would be expected to check the amount of such credit extension. Unfortunately, at times such as the postwar years, the effectiveness of that device is reduced by the large amounts of government bonds held by the banks. Thus, if the reserve requirement is increased, the banks can merely sell some of their government bonds and thereby increase their reserves to meet the new requirements.

Moreover, this and other devices which have the effect of raising the interest rate—an end which the government as stabilizer of the price level would presumably desire—have an adverse effect upon the government as our largest debtor. When we have outstanding a government debt of some $250 billion, the carrying charges will be materially affected by any increase in the interest rate at which refunding operations must take place. The government is thus in a Dr. Jekyll and Mr. Hyde position: in its one capacity, represented by the Federal Reserve Board, the desire may well be to tighten credit terms, that is, raise interest rates in order to keep prices in check, but in its other capacity of debtor it obviously needs low interest rates. The conflict points the moral that unusually large demands upon the government, other than those arising out of depressed prices and business activity, should be financed as largely as possible by taxes and by such borrowing activities as, for example, small bonds (of the E type) and as little as possible by borrowing of other kinds.

A sixth anti-inflation device is to restrict the flow of attempted purchases by tightening the terms of installment credit. This may mean increasing the amount of the initial payment, shortening the period of repayment, or increasing the rates of service and interest charges that will be applicable. While in-

stallment credit is not essentially different in its effects from other kinds of credit, it seems especially easy to show the way in which such credit increases the current demand and also decreases that demand at a later time. We can illustrate this by the effect upon an individual's purchases. Let us suppose that an individual has a current income of $300 a month and that he has been spending that entire amount. But now in a particular month he makes purchases of $100 on the basis of 30-day credit. His total expenditures during that month will then be $400. The next month he also buys $100 worth of goods on a similar credit basis, but he must use $100 to repay the 30-day credit extended to him in the previous month. The amount of credit outstanding to him has thus not been changed, but his possible purchases in the second month will decline to $300, the same amount as when he was buying on a cash basis ($300 income minus $100 to repay the debt of the previous month plus $100 on purchases on the new credit). A point often overlooked in connection with the extension of consumer credit is illustrated here, for it is clear purchases made on a credit basis decline when the credit *ceases to expand*. They do not, as some persons seem to think, decline only when the amount of credit declines. It is true that this latter stage would represent a still further decline in our individual's purchases as will be clear if we assume that in the third month he decides to go back to buying on a cash basis, for in that month he will have only $200 for expenditures: his income of $300 minus $100 to repay the debt. The general proposition can be made, therefore, that purchasing power is only enhanced by consumer credit during the period when one is adopting that basis and, for the country as a whole, when the amount of such consumer credit is increasing. Even in the normal course of development and without assuming a decline in current incomes, installment and other consumer credit finally reaches a saturation point. It reached such a point, incidentally, in the late twenties. The effect of this leveling-off in consumer credit is to cause, not a leveling-off in demand but a reduction in demand.

Despite these untoward later results, there are times, such as the depth of a depression, when the stimulus of installment

selling can serve a good purpose. There is also no inclination here to question the social values which may be provided by an institution enabling individuals of small income to put their large purchases more nearly on a par with their small purchases; but it does seem clear that, when there is danger of prices getting out of hand, it is the worst time to expand that method of purchasing.

At several points we have referred to the "attempts" of consumers to increase their purchases during periods of rising prices and full use of resources. The term has been used advisedly, for if the resources of the community are being fully employed, then quite clearly the consumers of that community cannot actually obtain more goods by bidding larger numbers of dollars. All they succeed in doing under such circumstances is to advance the ratio of dollars to goods and thus still further advance prices.

A seventh part of a general policy to prevent inflation would be to tighten the terms of mortgage credit used for construction. These terms are at least partially under government control. It may be argued that a time of housing shortage is a poor time to impose such credit restrictions, but to this statement it may be replied that the chief difficulty in such a period is the exorbitant cost of construction and that a reduction of such costs would serve equally well at that time and far better as to future settlements than a policy of easy credit. From the point of view of the individual home builder, for example, if he has $2,500 in hand and it costs $10,000 to build his house, he can build it providing he can borrow 75 per cent of the costs. But if the cost of building could be reduced to $5,000, he could then, with the same equity, build the house with a credit extension of only 50 per cent. The home owner is clearly in a better position as to his own future security on the second basis than on the first. For in the first instance, his equity would be destroyed by a drop in house values of only 25 per cent from $10,000 to $7,500, whereas in the second case his equity would not be impaired until the value of the house had dropped 50 per cent from $5,000 to $2,500.

In concluding this list of monetary, fiscal, and credit policies, which might be regarded as weapons in the government's arsenal for holding in check undesired fluctuations in the general price

level, two observations should be made. First, the list is by no means complete; nor can any complete list be set forth, because each case has certain unique features and, therefore, a number of devices can and will be proposed currently by economists and fiscal experts. In addition to the lessons which can be drawn from experience and deduction from principles, there must always be, and there surely will be, improvisation to meet the current problems. The second observation is that the listing and brief explanation of these policies may give an erroneous impression that the adoption of any of them would contribute to a solution. Such a conclusion would be an oversimplification. In some ways which we have seen and in many others not mentioned, these policies are interrelated and, therefore, to adopt certain of them without others might do more harm than good. Moreover, it is very difficult to judge their combined quantitative effects. When prices are rising at an alarming rate, as they were in the postwar period, it seems clear that the brakes should be applied to avoid a disastrous crash. But to apply the brakes too hard or in the wrong way may precipitate the crash which we were trying to avoid, just as unskilled application of the brakes of a car may throw it into a disastrous skid. As was said in the *President's Economic Report to Congress* in January, 1948, concerning control of bank credit: "It is not a simple task, nor is it free from dangers. Unwisely used, it could overplay its role and precipitate an undue liquidation of credit and a lowering of economic activity."

A number of the suggested policies have involved the creating of a government surplus of receipts over expenditures. This object will be advanced, of course, by reducing government activities and expenses as well as by increasing its receipts. And to the extent that it is feasible, a reduction of government expenses is especially to be desired in a period of rapidly rising prices, although an expansion of activities and expenses may be appropriate when there is a pronounced trend in the opposite direction. It is not easy to institute a policy of government economy during a time of rising prices because, in the first place, the costs of normal governmental services increase during a period of high prices just as do other costs, and, in the second

place, during such a period national income is likely to be high, and it is felt that the community can afford to bear high taxes. Therefore, the normal resistance to a number of proposals for increased government activities is at a low level. People have a tendency to view the government much as they would view their own business and thus to feel that a time when its income is large, or can readily be made large, is the best time to undertake expensive projects, and in this popular view the time for economy is when the national income is low. From the point of view of stabilizing the price level, much can be said for precisely the opposite policy, which would mean deferring large governmental projects during prosperous times and times of high prices and putting them into effect in periods of low business activity and declining prices. To get the government to follow such a course requires, among other things, a better understanding on the part of the community, and particularly the business community, regarding certain distinctions between the position of government and business in their income receiving and spending activities. A high degree of understanding on the part of the members of Congress and a willingness by them to resist the popular pressures of the moment are also required.

So far, we have examined a number of government activities which might be expected to affect the supply or the use of money and thus to have a desired effect upon the general level of prices. But as was said before, the price level depends upon the relation between this demand in monetary terms and the supply of goods. We now consider the possibility of influencing the price level through affecting the supply of goods and, specifically, of checking inflation by increasing the supply of those goods. It has often been suggested that the real cure for inflation is increased production. In the long run this is no doubt sound, but in the short period it is fraught with difficulties. Inflation frequently appears at a time when the productive resources of the country are employed at a high level. Under such circumstances, increased output is likely to call for increased plant and other capital equipment; but the immediate effect of attempting to increase the stock of these capital goods is, of course, to increase the demand for goods and services in general and thus

to contribute to the inflationary pressure rather than to discourage it. The long-run effect upon production is obviously to be desired, but the short-run effect is to support or to further raise the price level. Also, increased production calls for the adoption of such devices as increased overtime at higher rates (and, therefore, at higher costs) and the employment of marginal workers, that is, less efficient and less eager ones, which also contributes to higher costs. If the country is operating close to the highest practical level of production, any effort to solve the problem of inflation by going beyond that level will be self-defeating. Of course, if a tendency to inflation appears at a time when the productive resources are only partially employed, as was true, for example, in certain European countries after World War I, then this proposed line of attack would be more promising.

However, there are other ways in which larger production might be encouraged. These involve the removal of obstacles to most effective production. The reader will think of a number of such policies. They would include a lowering of barriers to trade, for such barriers mean that production is carried on in less efficient ways and places than it would be if trade could move freely. There are numerous barriers, for example, to interstate trade. Likewise, if we take a world view of the problem, barriers to international trade act in the same way. There are also a number of restrictive policies followed by certain labor unions which keep production below its maximum level. And, of course, any restrictions upon production instigated by trade associations, groups of manufacturers or retailers, or other producer groups in the community would fall in the same category. Merely to mention these obstacles suggests that, having been built up over years and decades, their correction is not likely to be sufficiently prompt to act as an immediate weapon against rising prices. A period of rising prices, however, is a favorable time for striving to rid the economy of such restrictive practices, partly because the public at that time is keenly aware of the need for more goods and also because the fear of unemployment as a result of the sudden relaxation of such established policies will be at the lowest level. Such efforts are,

therefore, to be commended on general grounds, even though they may not be highly effective in solving the immediate problem of inflation.

## SPECIFIC PRICE CONTROLS

All of the suggestions which have been made here for controlling an undesirable advance of prices have been directed to correcting the maladjustment of dollars in pursuit of goods and the supply of those goods. The suggestions have all been designed to decrease the former or to increase the latter or to do both. But there are those who believe that the problems should be attacked by the more direct methods of government price fixing, rationing, and other administrative devices and that a program of that kind should be adopted either as a substitute for the other remedies or as a supplement to them. If our diagnosis of the nature of inflation is correct, these proposals merely strike at symptoms, not at the basic causes. If the government rules that the prices of some things may not rise, there will first be various and ingenious devices for avoiding the ruling in which buyers and sellers will often co-operate (black markets). If these devices are put down, then the dollars which are thwarted in their pursuit of those goods turn in greater numbers and increased vigor to other goods.

The goods to be selected for such special controls will likely be those that are described as in "short supply." But the remedies of short supply of particular goods are best found in the normal functioning of a free market. These functions are to reduce the effective demand of consumers and industries for these goods because of the *relatively* high prices for them, and, for the same reason, to stimulate the ingenuity and efforts of producers to increase the supply. Thus, the market forces impinge upon demand and supply—the twin causes of price.

But even if these views are accepted, two reasons remain for demands for specific price controls. The first is that the community or some politically potent groups in it may feel that the prices of certain items, rents, for example, must be held in check for one reason or another. Against this attitude, it can be said that this kind of control may influence the prices of those par-

ticular things but will not materially affect the general price level. The second reason is that certain items hold important strategic places in the whole scheme of prices. For example, rents or prices of meat may loom large in the index numbers of cost of living which play an important role in wage negotiations. Hence, it may be argued that to allow those key items to rise would set off another round of wage increases which would raise costs and prices over a broad front, whereas advances in prices of personal services, entertainment, and minor luxuries (cigarettes) would not have the same psychological effect, even if they are bought by the same classes of people, and would have the same effect on the actual cost of living. People do react differently to high prices of bread and beer even though one may be as firmly established in the standard of living as the other and, hence, have as much effect on the cost of living.

Our endorsement, therefore, of the assumption of responsibility by the government for the general price level is in no way an abandonment of a belief in the efficacy of a free market to perform the functions for which it is suited. But to repeat what was said at the beginning of this discussion, those market functions do not include a regulation of the value of the currency, that is, the *general* price level. That, like the setting of other features of the general environment within which business operates, must, we believe, be assumed in large part by the state.

## PROBLEM OF A DECLINING PRICE LEVEL

So far we have discussed the problem of stabilizing the price level primarily from the point of view of checking an undesired advance in prices. We now turn to the opposite problem created by an excessive decline of prices. In the discussion of the former, we noted at a number of places how certain policies could be put in reverse, and thus the remedies for declining prices are to some extent the opposite of those for rising prices. It is therefore not necessary to deal with this question in such detail as the previous one.

Just as it is true that a rising level of prices is frequently accompanied by a rising level of business activity and a rapidly rising price level by feverish activity, so we can observe that

declining prices, and especially rapidly declining prices, are frequently accompanied by declining employment and other evidences of a low level of economic activity. Some writers seem to imply that the price level and economic activity are so closely and causally connected that they can be treated as the same problem. That apparently is an exaggeration, as can be seen by the commodity price trend in the late twenties and again in the period 1933–37; in the former period a gradual downward drift of prices was accompanied by a great increase in economic activity, and in the latter period a very slight improvement of prices was accompanied by a very marked advance in activity. The truth seems to be that a greater degree of price stability would contribute substantially to general economic stability, but there are enough other factors involved to make it impossible to draw the conclusion that a depression can be cured solely by raising or checking a decline in the price level. The checking of a decline in prices may help to overcome a depression, but there are other factors essential to bringing about that result. While, therefore, the following comments may have some bearing on the occurrence and continuation of depressions, they are not directed exclusively to that broad problem. A stable price level is regarded as contributing to a healthy expanding economy: the checking of a radical change in the price level is not merely a specific remedy for a pathological condition.

The problem of checking a decline in the price level is again the relation between the number of dollars being paid against a supply of goods and services. It is a characteristic of price that it will adjust itself at a point which will equate the demand and the supply. Thus, if a demand to the extent of $1 billion impinges upon a supply of goods and services which would be represented by one billion units in physical terms, the price of those units would naturally be $1.00. If now the demand drops to $500 million and the supply of goods and services remains the same, the price would be expected to settle at 50 cents. Thus, the declining price could be caused by the declining demand, and the remedies would naturally be sought in increasing that demand. We should bear in mind, of course, that the demand is the number of dollars *being offered*, which is a product of the

number of dollars in existence and the eagerness of people to exchange them for goods. The demand side is not, therefore, determined merely by the quantity of money.

This same relationship could be stated with emphasis on a changing supply, and then we could visualize a situation in which the demand continued at $1 billion but the supply of goods and services increased to 2 billion units. This situation also would lead to a decline in prices to 50 cents per unit. But putting the problem in this way would suggest that the remedy should be found in restricting the supply of goods and services in order to retain the old price. In fact, it is not usually possible to describe a maladjustment in either of these ways. Nor is it necessary to do so, because it is always the relationship between the demand in money terms and the goods and services in physical terms that is important. There are, however, important reasons why the restriction of output is an undesirable line of attack. The basic reason is that, at least in the present development of the world, there is always a need for more goods and services and the fundamental harm to public welfare created by restricting production would be greater than the gain in stabilizing prices, even admitting that this line of attack might bring about the latter result.

It has been necessary to mention this possible attack because, to many people, it seems quite obvious that a declining price level is caused by an oversupply of goods and services. The superficial evidence seems clearly to support that view. Producers of all kinds—businessmen, farmers, workers—observe that the force compelling them to reduce prices of their goods or services is oversupply of such goods and services. This attitude was particularly noticeable during the thirties; and a number of our policies of government, business, and labor were predicated on the assumption that the solution of the problem of declining prices was to be found in reducing production. The farmers approved and the government supported an agricultural program aimed at restricting production and going so far as to reward farmers for not producing products. Labor unions followed policies of restriction of entrance, reduced hours of labor, and slowdown of work. Businessmen, at least many of them, supported

the N.R.A. program, which had as one of its effects restriction of output consistent with the declining demand. It is to be expected that this solution would again become popular under similar circumstances, and it is important that we recognize the fundamental fallacy of it. The fallacy lies in the fact that the major reason for desiring stable prices is the belief that they contribute to a high level of production and a high standard of living. An apparent remedy, therefore, which directly reduces production is no remedy at all.

If it is true that the price level is determined by the relation between the demand for goods in money terms and the supply of goods in physical terms and if we find compelling objections to correcting this relation, during a period of declining prices, by a restriction of the supply of goods, it follows that the only remedy left is an enhancement of the demand for goods. If we are to attack this maladjustment of demand and supply through increasing demand rather than through decreasing supply, there are a number of things the government can do which generally are the opposite of what it should do to check a rising price level and which we considered in that connection in previous pages.

If it is desired that people should offer more dollars for the existing supply of goods, it seems clear that more dollars which might be spent should be left in the hands of those people. The government can influence this supply of disposable dollars by its tax policy. The first and perhaps most important change would be to reduce the total amount of taxes. But if the government reduces the amount of taxes and, at the same time, reduces its own expenditures by equal amounts, the effects would apparently neutralize one another, for the government is one of the large demanders of goods and services. At such a time, therefore, there should be no general reduction in government expenditures. This combination of policies will necessarily require a government deficit. It is suggested that a deficit created by a combination of government expenditures at their old level with declining revenues from taxes is justifiable, just as the collection of revenues in excess of current needs is justified for combating rising prices.

Aside from reducing the total tax revenue, it would seem that

it is especially important that the tax burden be reduced upon those persons who would otherwise spend their dollars. If an individual pays to the government in taxes $100 which he otherwise would have spent and the government spends that $100, there has been no increase in the aggregate demand. This suggests that, when a conscious effort is being made to check a decline in prices, there should be a re-examination of the tax system. A sales tax, for example, seems quite obviously undesirable at such a time because it bears especially upon people who would otherwise spend the money. Thus a tax which would serve a useful purpose in combating inflation would be quite out of place here.

When we say that the government should reduce its tax collections, it is not necessary to assume that the tax rate would be reduced. On the contrary, tax revenues under these conditions will inevitably fall unless the tax rates are raised or new types of taxes are levied. This will happen because tax revenues are so closely geared to national income. In effect, then, the proposal is merely that tax *rates* not be raised in time of acute depression; to do so in an effort to balance the budget would have the effect not only of removing dollars from the aggregate purchasing power but also of discouraging enterprise at a time when it very much needs to be encouraged. Moreover, from the long-run point of view, a stable tax *rate* is to be desired for intelligent business planning.

If it is desired to further support the disposable income of a country and the price level, another method to accomplish this may be for the government to expand its public works program. There are many economists who attach considerable importance to this device both as a means of combating unemployment and as a means of supporting a sagging price level. There is much to be said for such a policy, especially if it involves only the timing of public works. Some public works are of such a nature that their need, although real, is not immediately pressing; and they can, therefore, be undertaken at such times as the government may choose. For example, it seems only reasonable to construct needed public buildings during a time of low prices. The government will get better buildings at lower costs, and the demand

created for building materials and labor will come at a time when it is needed, rather than at a time when its effect would be to raise the level of prices that may already be undesirably high.

But while the advantages of such a compensatory public works program are quite obvious, there are objections. In the first place, many of the public works which are needed, in the sense that they are regarded as worth more than their cost and can, therefore, be justified aside from any supposed effect which they would have upon employment or prices, are most needed at the very times when prices are high and business activity is at a high level. In other words, the supposed distinction between the needs of government for school buildings, post offices, roads, and so on, and the needs of private builders is not as great as it is sometimes pictured to be. This, for example, was shown immediately following World War II. Everyone admitted that that was an unfortunate time to engage in public building. But the need for additional space in our universities, to take a single example, was so great that no reasonable alternative was offered. The fact that this need came at the same time as the high demand for private construction was more than a coincidence; for in a time of great economic activity, such as frequently accompanies a rapidly rising price level, all needs, public and private, increase together.

A second objection to this line of attack on a sagging price level and depressed trade is that, in spite of efforts that may be made to avoid competition with private industry, the stimulated demand for materials and labor does increase costs. Especially is this true if the government adopts a policy of paying wage rates above the necessary market level on the ground that the American standard of living would be impaired by reducing them. A third objection to considerable extension of public works and other types of government employment at such a time is that it is very difficult to reduce such activities when the temporary need has passed. Thus, the period of sagging prices or of declining demand becomes an occasion for extending permanently the area of government activities at the expense of the private sector of the economy.

Despite these objections, it is probable that in any period of sharply declining prices such activities should be undertaken. The objections just mentioned, if borne in mind, might help to a more wise choice of particular projects and wise control of their amounts than would exist if an uncritical program of compensatory spending were adopted.

How is the envisaged deficit in government finance to be covered? It could possibly be done by sale of bonds to the public, but that would have the effect of withdrawing spendable dollars in only a somewhat smaller degree than would the collection of taxes. The alternative of creating a debt to the banking system seems more appropriate at such a time because it would have the effect of producing a net increase in potential purchasing power. Again, it will be noted that this is precisely the opposite of the suggestion made for combating inflation by retiring the government debt to the banking system rather than the bonds held by individuals.

The importance of paying attention to the details of fiscal policy is illustrated by this choice of the kind of debt to be created and of the persons or institutions to absorb it. Indeed, at a time when the government is increasing its net indebtedness as part of a program of sustaining the price level, it would not be unreasonable that the government should be repaying the debt held by small investors who might be expected to spend the money which they received from the redemption or sale of their small bond holdings.

The deficit financing implicit in these suggestions has been the subject of heated discussion engendered by differences of views on the policies followed during our depression of the thirties. On the matter of a government deficit, no simple endorsement or condemnation is possible. How the government secures its tax revenues, how it provides for additional funds, and how it spends its funds are all relevant questions. As to the effect on the price level, the answers to these questions are important. For example, if a tax were not levied upon a person or class of persons, how would the funds left with the taxpayers be used? Would they be saved or spent, and how? As to money paid out by the government, will it be largely spent

or saved? And, as indicated in the preceding paragraph, when bonds are sold, the question is: Who is affected and what effect does the sale have on the supply of disposable funds in the hands of the public? These are questions even more important than the simple fact of a deficit.

Moreover, the policies suggested do not imply a continuing or continually growing public debt. The concept is one of balancing the budget, but over a period of good and bad times instead of in each annual period. There are those who argue that, if a government deficit is justified in an effort to support a price level (or to stimulate employment), it can and should be used regularly for that purpose, and there is no need to repay the debt. The suggestions made in this chapter are intended to imply that there is a time for incurring debt and a time for repaying it. The second phase is fully as important as the first.

In addition to the influence which the government may exert upon the amount of disposable income left in the hands of consumers, and thus available for expenditure, it can perhaps also do something to facilitate an increase in the volume of bank credit. It should be borne in mind that, at a time when prices and business activity are declining, the government cannot itself determine the amount of bank credit extended to private individuals and enterprises. The government's power to change reserve requirements, for example, is merely permissive, that is, the government makes it possible for banks to extend credit somewhat more freely *if* they wish to do so and *if* businessmen and others who borrow from the banks wish to borrow. For example, during the thirties a policy was followed of striving to increase the supply of credit. This policy was not notably successful because the positive reasons for wanting to use credit were lacking. The situation is illustrated by the fact that if the water trough is reasonably full, you cannot encourage a horse to drink more by putting more water into the trough. Or, to change the figure of speech, "A man does not increase his girth by lengthening his belt." However, one cannot generalize all possible situations from the experience of the thirties, and there may be times in which the liberalizing of

bank reserve requirements and, even more, government influence to liberalize installment selling, mortgage terms, and so on, may be effective. Whenever that is true, these devices could quite properly be used as a means of supporting the price level.

One of the most illusive factors needed to combat declining prices is an increase or a reinstatement of business confidence. But illusive as business confidence may be, it is probable that, by one method or another, this result must be accomplished. The reasons for this view have been made clear in previous chapters in which the importance of the role of the enterpriser upon the demand for goods and services was stressed and in which the importance of confidence as a basis for that expansion was indicated. The demand for goods and services is heavily dependent upon the decisions of these enterprisers; for their demands, when made effective, produce purchasing power among all levels of business and among consumers and thus tend directly to redress the unbalance that exists between the demand in monetary terms and the supply in physical terms. Also, the effect upon the amount of bank currency, i.e., bank credit, has just been noted. It is not, therefore, necessary to labor further the key position which business confidence holds in the problem.

But how to improve that confidence is not so simple. One of the most important requirements is that the government should be aware of the primary importance of this element and should let it be known, through the words of its spokesman as well as by its every act, that it desires to create an environment favorable to business. It can hardly be overemphasized that an atmosphere of hostility on the part of government toward business, or a belief on the part of business that such an attitude does exist, will rob many specific activities of such beneficial effects as they might otherwise have. For example, the deficit financing program carried out during the thirties might have been presented as a means of supporting a market in which businessmen could hope to make profits. Instead, it was too often accompanied by criticisms of the profit motive itself, a minimizing of the importance of private enterprise, and a threatened policy of permanent extension of government activities at the expense

of that enterprise. Under these circumstances the expenditures by the government had the effect of impairing confidence rather than improving it.

When business confidence is at a low ebb would seem to be the most appropriate time for making tax reforms in the direction of removing burdens from enterprise or, at the least, it would be the worst time for holding forth prospects of higher taxes upon business. If assurance could be given at such a time that—while the whole community, including businessmen, would be expected to pay higher taxes as prices and economic activity rose—there was no plan for higher tax rates, it would have a salutary effect.

Another policy of government that would contribute to business confidence would be to refrain from attempts to support costs which were too high.Such a suggestion, of course, presents the problem that we desire increased incomes paid to the factors of production—to labor, for example—without causing an advance in costs. This is not logically so difficult as it might appear at first sight. A policy of downward revision of wage *rates* at such a time might well have the effect of increasing the total employment of labor to such an extent as would yield an increase in the total amount paid in wages. The business enterpriser, largely influenced as he is by profit prospects, is concerned with the level of wage rates because they have such an important bearing upon unit costs. This opposition does not extend to the total volume of wages. Indeed, it must be clear to any enterpriser, especially one selling to a mass market, that an improved volume of wages is necessary for the disposal of his goods. A failure to see this distinction between wage rates and the total amount of wages or, at least, to act upon it no doubt contributed to the decline in prices and volume of production in the years immediately following 1929. The policy recommended by President Hoover, followed by his successor, President Roosevelt, and endorsed by some public spirited industrialists and by labor leaders was to maintain the "American standard of wages." It now appears that what was needed was to maintain the total volume of wages rather than the wage rate and that the effort

to maintain the latter contributed to a failure to maintain the former.

Several groups must join to carry out such a policy. The government, in so far as it influences wage policy, must have the courage to swing that influence toward flexible wage rates, which at such a time would probably mean reduced hourly rates, in the hope of increasing the volume of employment and the total wage bill. Workers and their representatives must take the view that it is better to be employed at a somewhat lower wage rate than to be unemployed at a higher rate. And businessmen must be willing, on the basis of reasonable profit prospects created by lower costs and a reasonable tax policy, to undertake an expansion in production and particularly in the introduction of improved plant and equipment.

## NEED FOR A BOLD AND CONSISTENT POLICY

At a number of points, we have noted that the price level is a matter of concern to people primarily in their anticipations of it rather than in its actuality. This suggests the need for an avowed and well-established policy on the part of the government which is well understood by the whole community and for a confidence by the community that the government has the weapons and will use them to maintain a reasonably stable price level. A weakness of the past, and perhaps an unavoidable weakness in a democracy, is that no such long-run policy has been enunciated and that the efforts to affect these important economic trends have been made in a weak and vacillating manner. The essential parts of a policy to control the price level are, then: first, that the government should indicate its firm intention to stabilize the price level, and, second, that the actions of the government will be bold and sufficient to accomplish this result.

Finally, there are those who feel that any such bold and strong policy on the part of the government would be inconsistent with the philosophy of a free system. A policy of this kind will surely be described by some as an attempt on the part of the government to control the whole economy. It is our view that a successful free system does not require nor, indeed, can it

continue with a weak and vacillating government. The requirement is that the activities of government should be of such a general type as will maintain the standard units with which the business game must be played. That is quite a different matter from attempting to dictate the conduct of individuals within that environment. More will be said on that philosophy in Chapters 21 and 22. But it should be mentioned here because this is one of the places in which there is disagreement among the supporters of a free system, and there is danger that, through their own confusion as to the proper role of government, these supporters will play into the hands of people who really do favor a genuine control of the whole economy.

## PRICE LEVEL OVER THE LONG PERIOD

As the community becomes more productive, we should expect to and will, in one way or another, attain a higher general standard of living. How is that standard of living to show itself? It might be argued, for example, that with the progress of an economic society the level of wages in monetary terms should ideally remain constant, leaving room, of course, for individual wages to rise or fall, and that the higher standard of living should be realized by workers and others through lower prices. That is one way in which the improved economic position of the country could show itself. Another, however, is that the wage level in monetary terms should advance to reflect increasing productivity and the increasing marginal significance of labor and that this advance of wages should be accompanied by a stable level of prices for goods. In the former case, the worker has, as the result of his day's work, the same number of dollars; but his real income goes up because the prices of goods have declined. In the latter case, the worker has a larger number of dollars to spend for goods which remain at a constant price.

As between these two situations, there is much to be said for the second from the point of view of encouraging business commitments and expansion. The businessman needs assurance that the general price level will not decline; he does not need to be assured that wage levels will not rise. His concern is with unit labor costs, which are the resultant of the hourly wage rate and

the hourly output. For the encouragement of future commitments, a prospect that prices of the things sold will remain substantially constant and that the labor cost in dollars of producing those things will not advance, would suffice. Moreover, if the general price level for goods remains substantially constant over a long period of time, the economic progress which we can visualize, can take the form of increased rewards to the different factors of production in proportion to the supply of those factors and the marginal significance of each. For these reasons we conclude that a stable price level is more to be desired than a stationary wage level.

# 20

## *FOREIGN TRADE AND EXPANSION*

In a free enterprise system human desires for goods and services are expressed in the market, and goods are produced to meet the requirements of the market, that is, to meet the requirements of trade. In such a system the maintenance of a high level of productive employment depends largely, therefore, upon a thriving trade; and a program of expansion of production and employment should aim at removing barriers to trade and at facilitating the exchange of goods and services.

### SIGNIFICANCE OF FOREIGN TRADE TO THE UNITED STATES

Some who will accept this generalization may question whether it applies to our foreign trade as it does to our domestic trade. And there are others who will contend that, for the United States at least, foreign trade is so small as to be of little significance. It is true that we are primarily a domestic trading people. In quantitative terms our national income is normally derived from the sales of goods to foreigners only to the extent of 5 per cent or less of the total. And likewise viewing the national income as a sum spent, only a similarly small proportion is spent on goods imported from abroad.[1] These facts, however, understate the significance of foreign trade to us. The national income is derived from and spent upon many goods and services which, by their nature, could not enter into foreign trade. Our exports represented from 7 to 10 per cent of the value products of agriculture, mining, and manufacturing. Moreover, these figures are, of course, national averages, and the importance of the foreign market varies widely as between different industries. There

[1] In 1938 national income was $64 billion, exports $3 billion, and imports $2 billion. Proportion of national income received from exports was 4.4 per cent; spent on imports, 3 per cent. *Statistical Abstract of U.S.* (Washington D.C.: 1941), pp. 346 and 523.

are some industries in which the foreign market is crucial. For example, in 1938 we exported (in values) about one-half of our cotton, 40 per cent of our tobacco leaf, 46 per cent of our copper, 32 per cent of that highly fabricated group of products—cash registers, typewriters, and calculating machines, 65 per cent of our agricultural implements, and 18 per cent of our sewing machines.[2] For most of our industries foreign trade has at least a marginal significance; and for those listed and several others it is more than "marginal." The prosperity of these and other important industries depends heavily upon our foreign trade, and the indirect effect of the prosperity of such industries and of whole regions upon the prosperity of the rest of the economy is great. It is probably greater than it would be if exports were spread more evenly among all of the industries of the country.

Also, in many lines the importance of foreign trade has been much greater in the past, and the low levels recently reached are more an indication of the devastating effects of restrictionist policies the world over than of potentialities. For example, in view of the preponderant position of the American automobile industry, both in quantity and in effectiveness, the fact that only 7 per cent of its product was exported in the prewar period was not an indication of how important exports could be but of how seriously they had been hampered by international trade policies of the world—policies for which the United States could not escape some degree of responsibility.

## INTERESTS OF THE UNITED STATES

The interest of the United States will be advanced in certain specific ways by the expansion of our foreign trade. The advantage of international trade, from the point of view of increasing our effectiveness of production, is merely a special aspect of the general advantage of division of labor. That advantage is so clear it does not need lengthy discussion here. However, the fact that it applies equally in international trade sometimes escapes attention. Every country, like every individual, can make

[2] *Ibid.*, pp. 557–613

some things better than other things; and in the one case, as in the other, the role of practical wisdom is to devote oneself to those things in which one has the greatest advantage. The fact that the United States, for example, has, from the point of view of sheer effectiveness of production, an advantage over most other countries in a great many lines does not mean that it is, therefore, to the advantage of the United States to engage in producing all of those lines. The essential part of the proposition mentioned above is that we have greater advantages in some lines than we have in others. We may, for example, have as good land for the raising of sugar beets as any other country, and our workers may be as capable of doing the irksome hand labor involved in that industry as are the workers of any other country. It does not follow that we should engage in that industry, however, for there are other lines—for example, the machine-using industries—in which our advantage over other countries is more marked. Under these circumstances the net product of our industry will be increased by devoting ourselves to the production of machine-made goods and by trading those goods for foreign-produced sugar. We will thereby have more of the manufactured goods and more of the sugar. The fact that by such specialization productive employment will also be advanced in the sugar-producing countries will be regarded as an added advantage to people who accept the concept of "one world."

The demonstration of the advantages of territorial (regional or national) division of labor and of the proposition that the net productivity of the trading countries will be enhanced by following such specialization as is induced by free market forces, has, in the past, relied upon the principle of comparative cost. This principle is that, under conditions of freedom of trade, a country will tend to export those products in which it has the greatest advantage or the least disadvantage and to import those products in which it has the greatest disadvantage or the least advantage. From this principle it was deduced that production of the whole group of trading countries would be maximized and that the gains would be shared by all of them. The classical defense of this proposition has been subjected to criticism in

recent years largely on the ground that it relied too heavily upon the assumption that costs and, hence, advantages were directly dependent upon the amount of labor involved in the production of the different things in the several countries. But even if we recognize that trade takes place on the basis of monetary values rather than being a direct barter of goods and if we make other qualifications necessary to approximate more closely the facts of commerce, we are still warranted in the conclusion that unobstructed trade based on the desire to sell in dear markets and to buy in cheap markets would produce a reasonable approximation to an effective direction of the world's efforts and thus contribute to the end of maximizing production.[3]

A necessary part, of course, of such division of labor is trade, and the advantages in higher levels of production and incomes will be denied to us to the extent that we obstruct the free flow of trade. This principle is so basic that neither the world at large nor any country can realize its greatest potentialities for human well-being if it is disregarded.

It seems clear that production is increased by carrying it on in those places and by those people who are best fitted for the particular kinds of production. But this argument for extensive trade assumes that labor and other productive factors in the several countries are to be employed in one way or another, and it emphasizes the enhanced productivity of that employment. As we have argued in previous chapters, the effectiveness of work is the most important requirement of a productive economy; but especially in times of world depression another question arises and, indeed, may overshadow this one, namely, the effect which foreign trade will have upon the volume of employment.

This problem can be considered in two aspects. First, would the volume of employment be greater or less for a country which is regularly involved in trade with other countries than for a

[3] It would not be appropriate here to pursue further the theoretical differences on the bases of international trade. A statement of the classical theory is given in F. W. Taussig, *International Trade* (New York: Macmillan Co., 1928), and a number of other works, including C. E. Griffin, *Principles of Foreign Trade* (New York: Macmillan Co., 1934), chapters i and ii. The criticisms of the classical theory are well developed in P. T. Ellsworth, *International Economics* (New York: Macmillan Co., 1938).

country whose economy was self-contained? Second, assuming any given reliance upon such international trade, what would be the effect upon employment of a change in that position? The first question is relevant to long-time policy, and the second is relevant as a despression-curing device. As to the first question, we might start with an arbitrary assumption that a country had also a very low level of exchange within its own borders and that, therefore, individuals and areas produced largely for direct consumption. If that were true, people generally would be working at a low level of effectiveness, and it might be argued that they would have to work hard and long to eke out a bare subsistence. Their lives would be mean and hard, but there might be plenty of employment.

But now what of the question of the level of employment as applied to the United States? If we were trading with foreigners for some 10 or 15 per cent of our expenditures instead of some 5 per cent, would we, typically, have a higher or lower level of employment? Is the answer different from what it would be in the assumed simple and unspecialized economy just described? An essential difference is that in our country production, and hence employment, is undertaken for sale, not directly for use. Hence, the possibilities of expanding markets for goods becomes important. While that expansion of markets may come from the production of more and better goods for our own people, the existence of still wider markets the world over provides added possibilities of sales and prospects of profits.

The many countries of the world having large populations and, at present, low standards of living will quite evidently provide richer markets as their productivity and living standards rise. The growth and extension of technical knowledge can be expected to lead to this rise of living standards in those countries. In this anticipated progress of backward countries, there is a continuing growth factor with which the United States can well align itself. This is not a question of the relative values of the domestic and foreign markets. Our more effective industries will enjoy both markets, and they are the industries in which profit prospects are best and in which expansion can be anticipated.

A closely allied consideration is the possibilities of investment. In so far as there is a problem of oversaving in a highly productive economy, the problem can be partially solved by the opening of new fields for investment either within the country or overseas. Much has been made by some observers of the stimulating effect which our frontier had upon our economy in the nineteenth century. They regret the fact that there are no more Mississippi valleys to be developed; but at least from the point of view of capital investment, if not of outlets for population, it seems clear that the energizing of a new China—involving, as it would, great demands for capital funds and goods—would represent the equivalent of another Mississippi Valley. Likewise, there are large areas, such as the Canadian Northwest and the interior of Brazil, in which undeveloped resources are awaiting capital investment. The stimulating effect of such foreign investment comes from the export of goods, which is likely to be the merchandise side of the capital transaction. Thus, we lend money to Brazil for buying railroad equipment. The money is used directly or indirectly to buy American goods and thereby acts as a stimulus to production here. Then if the funds are used productively in Brazil, that increases employment and the effectiveness of employment in that country and makes that country a better market for our goods.

Now what of the effect of a change of policy on international trade? From the point of view of meeting a problem of mass unemployment, it is urged by some that the imposition of protective tariffs for home industries would help. It is urged that an increase in import duties would stimulate investment in the protected industries and that the effect of that investment, through the employment created in the capital goods industries and, in turn, through the expenditures of those employed workers, would be multiplied and thus provide a stimulus to employment generally.

To this line of reasoning there are certain objections. First, the tariff can only have that stimulating effect upon the protected industry by raising the prices of its products. That means either a reduced consumption of those products or less money left to consumers for expenditure on other domestic goods and

services, or both. In so far as the tariff reduces consumption of the erstwhile imported goods, it fails in its purpose to stimulate home producers and merely deprives consumers of the satisfactions previously realized through the consumption of imported goods now excluded; and, in so far as the imported goods are still purchased; the tariff reduces the dollars left with consumers for the purchase of other goods. Those dollars would merely represent a tax by the government upon consumption.

Second, the imports of one country are the exports of another, and thus this form of recovery effort of one country depresses the export industries of the other. It is a policy, therefore, that loses much of its force if it is followed by countries generally. To this its advocates reply that presumably all countries will not adopt it at the same time; and, thus, through a series of steps—each acting as a stimulus to employment—the effects would not completely neutralize one another.

A third objection is that the exports of the tariff-levying country will be reduced by the depressed purchasing power of the other countries, which would be induced by hampering their exports to us. To this assertion the advocates of the plan would reply that the depressing effects upon our exports will not be so direct and prompt as the stimulating effect on our erstwhile import industries and that, moreover, the disinvestment in the export industries cannot proceed apace with the investment in the import industries.

On all this, little can be definitely known, and we are forced to rely upon deductive reasoning.[4] It seems reasonable to say that, as a purely temporary problem, a spurt to employment might be induced by the sudden stimulation of any industry, export or import, and that, therefore, a general (international) program of reducing tariffs might have as great an effect as one of raising tariffs; and certainly from the point of view of effectiveness of work and volume of production the former is to be preferred. Indeed, if one is to follow this line of reasoning, it might be suggested that a subsidy out of the government treasury for the export industries (paid, let us say, on the basis of a

[4] See Fritz Machlup, *International Trade and the National Income Multiplier*, (Philadephia: Blakiston Co., 1943), for a detailed analysis of this question; and note particularly pp. 215 ff., in which the author takes pains to indicate that nothing in the analysis should be used as a support for protectionism, whether in the short run or the long run.

given amount per unit exported) would be preferable as a temporary and stimulating device. We would then, at least, be stimulating our more effective industries instead of our less effective ones. There would be more prospect that, when the depression was over, those industries would be able to stand on their feet, whereas there is little hope that the less effective industries will ever be able to do so. Despite the objections to subsidies in principle, it is suggested that here they are less objectionable than the increasing of artificial obstacles. Moreover, we should realize that a policy of stimulating the less effective industries by tariff protection is not truly a temporary policy, for the difficulty of most of those industries is due not to a temporary depressed condition of world trade but to their inherent disadvantages compared to producers in other countries.

Another reason that a policy of stimulating exports, whether by these artificial means or by allowing an inflow of imports, seems more soundly grounded than one of restricting imports is that whenever we encourage our most efficient industries, even at the cost of discouraging our less efficient industries, we will be encouraging those industries which use the larger amounts of capital. Production in the United States typically employs large amounts of capital, and particularly is this true of our most effective industries, which would be most stimulated by a freeing of trade. Even our most effective agriculture today relies upon the use of substantial sums of capital. It would seem, therefore, that a change to our more effective lines would have the effect of creating new demands for capital that would more than offset the diminishing demands for capital in those lines that now rely upon protection. Our conclusion, then, is that the United States has an interest in an extended foreign trade from the point of view of its influence upon employment as well as from the point of view of the effectiveness and productivity of that employment.

Another reason why we in the United States have an interest in world trade is in the effect of trade upon world peace. Despite some protests and arguments to the contrary, it appears that an extensive flow of trade over the world contributes to the basic conditions of peace.

In view of the distribution of the world's raw materials and

variations in climatic conditions, there are bound to be "have" and "have-not" countries. We cannot change that fact, but we can minimize its effects as a cause of war by establishing a free flow of goods which will make resources available on the basis of exchange rather than of ownership. To accomplish this result requires a free movement not only of materials but of those other goods with which the materials can be bought.

The problems of have-not countries in securing raw materials can rarely be traced to direct restrictions which the raw material countries or colonies place on exports of those materials—at least in peacetime. The problem is more commonly the inability of the have-not countries to secure the foreign purchasing power with which to buy the raw materials. This paucity of purchasing power arises in part from inadequate production in the raw-material-using country and in part from the restrictions upon *imports* by the raw-material-producing country. The problem of securing raw materials is thus largely a problem of selling other goods. A country may have no policy of restricting access to its raw materials, but it may still do so quite effectively and unintentionally by placing tariffs and other restrictions on its own imports.

The removal of those economic stresses and strains arising out of the uneven distribution of raw materials on the earth's surface requires a general reduction of obstacles to the free flow of goods and services of all kinds between countries. In short, trade itself can and does serve to break down the conflicts of interest between the have and have-not countries. It is the man-made obstacles to trade in general, and especially to imports, that prevent a complete solution.

Even more important than this consideration is the fact that traders generally desire peaceful conditions. Consider the seller in relation to his buyers under competitive conditions. Sellers are vying with one another for the patronage and good will of buyers, and, to put it bluntly, you don't want to shoot your customers. The relationship between the competitors themselves is, of course, not so friendly; but even here an important distinction between warlike rivalry and business rivalry should be noted, namely, that the object of warlike rivalry is to destroy

the enemy and the object of business rivalry is to advance one's own interest. The businessman's point of view, therefore, is characteristically to weigh the costs against the returns. One large corporation will not normally enter into a conflict with a rival corporation which must result in the extermination of one of them. To do so would involve such costs to the winner as to make it unprofitable.

To this statement it may be objected that business organizations do engage or have engaged in deadly rivalry, and it is true that, unless restrained by law, a large corporation might engage in such an extreme conflict with a much smaller organization because, under those circumstances, the cost of exterminating the small rival might be negligible. Likewise, a large nation, even when dominated by economic considerations, may invade the rights of or actually assert sovereignty over a small country unless restrained by considerations of the indirect effects or by an international organization; but if a nation is really dominated by purely economic considerations, it is not likely to initiate a war with another major power. The reason—with such countries as with business firms themselves—is that ordinarily the measures that would be necessary to destroy the competing country would well nigh destroy the victor. The businessman's psychology when conflict arises is likely, therefore, to be one of compromise.

The objective of destroying another country or of reducing it to impotence, regardless of the cost, is more likely to spring from that extreme nationalism which, in turn, inherited its ideals from knighthood and feudalism rather than from traders. The present-day inheritors of those ideals are more commonly found among professional military men, political leaders of the dictator type, landed proprietors (the Junkers of Germany), and occasionally the intellectuals who become obsessed with ideas of racial superiority and national destiny than among the "money-grubbing" traders. Indeed, the traders may well be objects of the contempt of the others, as was indicated in Hitler's attitude toward Neville Chamberlain and in Napoleon's remark about the English that they were "a nation of shopkeepers." The shopkeepers have, on more than one occasion, given a good

account of themselves when pushed too far, but they are rarely the instigators of armed conflict. If they must share responsibility for conflict, it is paradoxically in their tendency to yield and compromise (for example, Munich) in an effort to avoid it, when a firm position taken early might have preserved the peace. It is true that trade has, both in the distant and in the very recent past, been used as an instrument of warfare by national states. The worst of these instances, however, in modern times have been those where the national state dominated the traders, notably in Nazi Germany. A naturally peaceful institution, even scientific research or religion, may, in these days of total war, be used for warlike purposes.

The two-way nature of trade, of course, implies that a country which engages heavily in it will have large imports. These imports provide competition for some businessmen of the country. This competition appears in the form of reduced prices, and it is only natural that the domestic producers of these imported goods may object and may strive, through political means, to hamper such importation. The high-tariff sentiment in the United States, for example, has until recently originated largely with businessmen and more recently with agricultural producers. But the fact that businessmen do occasionally exert their influence to reduce the amount of trade does not constitute an argument against the view that trade itself is a force for peace.

To encompass these objections we can then conclude that mutually advantageous trade conducted by free individuals, under such regulations as are designed to foster competition, constitutes a pervasive force for peace. It is in favor of this kind of trade the world over that the United States should throw its influence both for its direct and selfish interest and for its interest in the preservation of the general peace, which is no less real if not so direct and selfish.

## POLICIES FOR FOSTERING TRADE

In the interest of an expanding and productive economy, as well as for other reasons, our policies should be directed to facilitating the free interchange of goods among the people of the world. Those policies in their broad aspects can be out-

lined, although the specific plans and devices to implement them must, of course, be adjusted from time to time and will not be discussed here.

The first objective of policy should be that of maintaining a peaceful world environment. While we have just argued that peaceful conditions will be encouraged by trade, it is hardly necessary to argue the related proposition that the development of trade will be encouraged by a peaceful political environment. An expanding economy for the United States and for the world requires that businessmen shall be able to lay their plans for trade, and particularly for the investment of funds, on a reasonably secure assumption that the completion of their plans will not be disrupted by war. Likewise, any attempts on the part of government to assist in the economic reconstruction and development of the world economy would be better directed if the overpowering consideration of future wars could be eliminated or reduced. For investments made with a view to their political and military consequences will obviously not always fit the economic requirements or be directed to the places where they will be most productive in an economic sense. Trade and peace thus have a cause-and-effect relationship which runs in both directions.

A second objective of our broad policy should be to strive for the ideal of economic freedom in international relations. One reason is that freedom in the world market is conducive to freedom in the domestic area, and vice versa. If a country engages substantially in international trade and thus submits its producers to the competition of foreigners, it will be more difficult for the domestic producers to follow restrictionist policies and to advance the prices of goods or services which they have to sell. This salutary force of foreign competition applies to all forms of monopolistic controls. It will be more difficult, for example, to establish a cartel or other combination of manufacturers to allocate markets, to restrict production, and to raise prices if those manufacturers have to face the competition of producers from all parts of the world. Likewise, efforts on the part of monopolistic labor groups to raise their wages beyond a level justified by their productivity will be checked if these

workers are producing products which could potentially be imported; for a wage which is too high will lead to such importation. If these workers are engaged in export industries, an excessively high wage will also make it impossible for the industries in which they work to sell in foreign markets. In such ways freedom of trade between nations tends toward a competitive, free market, adjustment of prices and wages within the country. On the other hand, if wages, prices, and the direction of production within a country are determined by free market forces, that fact in itself will tend to encourage the exporting of some products and the importing of others. Thus, international trade is fostered by economic freedom in the domestic market.

In summary, freedom of trade tends to be an indivisible system. The maintenance of a free market at home is both aided by and gives support to a free trade policy in the foreign field. These relations are illustrated in the increased emphasis in recent years upon economic planning in the domestic sphere of some countries and the use of more interferences with international trade. When England, for example, embarked upon a policy of more extensive and detailed economic planning within its economy, it was not surprising that it departed from its traditional free-trade policy and suddenly found merits in protectionism. That the same policy should be recommended as to our domestic trade and our foreign trade is, therefore, not a coincidence, nor does it represent a doctrinaire striving for consistency, for the two areas of trade cannot be isolated one from the other.

An American policy of freeing the channels of world trade involves removing barriers to trade that have been erected by us and participating in joint efforts toward reductions by other countries. In the case of the United States, our chief barrier to trade has been the protective tariff. In some other countries the general tariff has been overshadowed in importance by national exchange controls, bilateral trading agreements, manipulation of exchange rates, import quotas, and other devices that, in some respects, are more seriously hampering than the "old-fashioned" tariff. But these restrictive policies are cumulative, and restrictions imposed by us in one form have, in the past, contributed to the adoption of other forms in other countries. Because of the

importance of our trade to the rest of the world, our international trade policies, even when we act alone, exert a great influence. That influence will obviously be enhanced if it is also directed to the lowering of barriers abroad. A policy of freedom on our part, therefore, should express itself both in our national decisions on our own foreign trade and investments and in an extension of our influence to international decisions.

Our own national decisions that will directly result in removing trade barriers will be those involving the tariff. Imports are needed to supply consumers with some goods not otherwise obtainable and with other goods at lower costs. Likewise, imports are needed by some industries to enable them to secure needed materials and by others to enable them to reduce costs and thus to expand production and sales in the domestic market and, even more, in the foreign market where protection on finished products cannot offset high production costs. They are needed further as the foreigners' means of payment for our exports. It is gratifying to be able to say that, at the present time, Americans seem finally to have recognized the importance of this aspect of our economic policy. However, the forces making for protectionism are not easily laid to rest, and, if we are to resist them in bad times and good, our faith in the principles of freedom must be grounded upon a broad appreciation of our interests and of the extent to which they are tied up with the economic interests of other countries. For example, on a number of specific questions the bearing of the principles of trade, and particularly of the requirements of the balance of trade, is frequently overlooked. Our attitude toward a national merchant marine is a case in point. While there are military considerations which prudent statesmen must take into account, we should recognize that, if we do haul our own goods, we must be willing to accept larger volumes of imports—relative to exports. In the past, one of the foreigners' important means of payment for our exports was in the supplying of shipping services to us. If we now propose to maintain our exports and also to supply our own shipping needs, we must be willing to accept imports in greater volume—either that or, via loans later defaulted, give away the exports. One cannot intelligently discuss our merchant marine policy

without reference to our import, i.e., tariff policy. Shipping services are, of course, only one of the items in our balance of trade with the outside world. Others, including tourist expenditures, interest receipts, loans, gold shipments, and investments, have a bearing upon one another and upon the volume of our exports. Putting it broadly, we cannot intelligently discuss exports without reference to imports, "visible" and "invisible," any more than a businessman can (or should) think of sales without reference to collections. A policy of expansion of exports is perforce a policy of expanding imports or, at least, import items, tangible or otherwise.

## UNILATERAL OR RECIPROCAL TARIFF CHANGES

In the making of changes required to free the trade of the world from artificial barriers, a question of procedure arises as to whether such steps should be taken by this country alone, by reciprocal agreements reached by bargaining with other single countries, or by concerted action of several countries. To a large extent, but not entirely, this is a question of political expediency rather than one of principle.

The ideal way to reduce such barriers, other things being equal, would be through the concerted action of as many countries as possible and, at least, of the leading trading countries. In the past, programs of this kind have frequently been disappointing. It has not been too difficult to get the representatives of a number of countries to agree in principle to a removal or reduction of barriers, but to get those results actually accomplished by the several countries has too often been another and more difficult matter. A more promising result was achieved in the Geneva Conference of 1947, in which substantial reductions of tariffs were effected, and in the formation of the International Trade Organization at the Havana Conference of 1948. Both of these conferences, and particularly the latter, fall short of the ideals of freeing the channels of trade, but they provide a basis for hope that this method of approaching the many and complicated problems of economic relations through international agreement can be more effectively employed in the future than in the past. It should be recognized,

however, that these conferences came at a time when the needs for economic reconstruction were painfully obvious, when the United States was inclined to take the lead, and when it was in a particularly strategic position to exert its influence. These conditions may change, and we are, therefore, not justified in concluding that we have finally perfected a permanent device for dealing with such problems.

A second approach to the problem is through negotiations between an initiating country and other countries individually. This is a policy which we have followed in the past several years through the so-called "Hull agreements." The policy was one of reciprocal agreements made by us with one country after another but with the benefits of reductions in tariffs generalized to others. This latter feature is, of course, an important part of the program, for discrimination in the treatment of foreign countries is even worse than the maintenance of high tariffs which apply alike to all of them. During the thirties the program was more important in its psychological effect than in its tangible results, although some definite progress was made, and no doubt the tangible results would have been more substantial if the war had not intervened. The efforts of the Secretary of State, Cordell Hull, deserve the warm commendation of liberals in that, during a period of extreme nationalism and economic warfare, the principle and hope of return to mutually advantageous freedom of trade were kept alive. In the postwar period this policy has shown more substantial results.

On the score of principle, this policy of reciprocal trade agreements, however, carries an unfortunate implication of mercantilism, and the support which it has gained in the United States has unfortunately been based on these grounds. The theory as it has been accepted in this country is that we grant to foreign countries the favor of admitting their goods into our markets in return for an equivalent favor of sending our goods into their markets. This is like saying that a farmer will agree to accept shoes as a favor to the shoemaker, who, in turn, grudgingly agrees to accept the farmer's potatoes. Basically, such a view of the advantages of trade does not make sense. The advantage to the farmer is in getting the shoes, and the advantage to the shoe-

maker is in getting the potatoes. A necessary cost to each is the providing of goods to the other. But in our international dealings we have come to reverse the reasoning and to think of the supplying of goods by us as the desired end and the acceptance of foreign goods as the perhaps necessary evil. This is not intended as a criticism of the Department of State. It was perhaps necessary at times to use questionable reasons to gain good ends. But if we are to maintain a broadly conceived policy which is truly in our interest, one would feel more optimistic if it were better grounded in sound reasoning.

A third way to bring about the reduction of tariffs and other barriers is simply for a country which has decided upon that policy to reduce its tariffs. As Senator John Sherman once said regarding the resumption of specie payments after the Civil War: "The way to resume is to resume." Such a method has a precedent in the repeal of the Corn Laws in 1846, which was one of the important steps leading to complete free trade in England. There is, incidentally, an interesting parallelism between the position of England after the Napoleonic Wars and the position we occupy after World War II. The lowering of trade barriers by England led to its great period of expansion of merchandise trade and loans and to the greatest expansion of trade and industry the world over that we have ever known. Such a policy, which at present seems to be that of the United States, will, it is hoped, provide both an example and a tangible reason for other countries to follow a similar course.

Recent estimates of average tariff rates imposed by the United States indicate that by the several methods outlined very substantial reductions have been made. Precise figures are not readily secured because some tariffs are levied as a proportion of value (ad valorem) and others in terms of physical units of goods (specific). But an approximation can be attained by reducing all to equivalent ad valorem rates. Using this method, it is estimated that the rates in 1948 (after the Geneva agreements) were about 15 per cent on all our dutiable goods and 6 per cent, if all imports, free and dutiable, are considered. These rates represent reductions from 37 and 14 per cent respectively

in 1939; and 53 and 18 per cent in 1931.[5] It should be recognized that average rates paid are affected by the shifts in the nature of our imports, but, after making all qualifications, it is clear that this country has moved far toward a low tariff and that we are finally taking the lead among the nations in that direction.

## REGIONALISM

By these various methods—general international agreements, reciprocal agreements, and unilateral action—we may hope to make progress toward the elimination of the artificial barriers to trade and to the flow of capital. We cannot expect that a broad reversal of world trends can be effected in a day. The economic relations of some countries are closer than those of others. A recognition of this fact has led to a movement for bringing together, into customs unions, groups of countries, generally contiguous, who will attempt to establish within that union such free trade and mutually helpful relations as might ideally be desired for the whole world. Many efforts have been made in the past in this direction. One of the early ones was the establishment of the German customs union in the middle of the nineteenth century which abolished barriers between several German states and contributed to the establishment of the German Empire. There have later been movements toward Pan-Americanism, Pan-Europeanism, and "The United States of Europe"; there has been the formation of a union of Belgium, Netherlands, and Luxembourg under the name The Benelux. Are such movements to be regarded as a step in the right direction? It may well be argued that they are, on the ground that part of the cake is better than none at all, and on the ground that, if the group is well conceived, a considerable degree of international division of labor can be worked out within it and, thus, that some of the major advantages of world economy can be realized here on a smaller scale. The defenders of such arrangements may also argue that the demon-

[5] Economic Research Department, *Economic Intelligence* (Washington, D.C.: Chamber of Commerce of the U.S.A., 1948), Report No. 4, p. 1.

strated advantages of trade between neighbors will provide a basis for extending the principle more broadly to ever larger areas and finally to the world economy.

On the other hand, precisely the opposite conclusion may be defended on the ground that, when such areas are set up, the necessity of trade over larger areas is reduced. Support for this view can be found by analogy in the history of this country. The policy of the United States during much of our industrial development and until recent years has been one of high protection and economic isolation. No doubt an important reason for that policy has been the fact that we have, within our own boundaries, one of the largest free-trade areas in the world. The wisdom of the founding fathers of this country in prohibiting tariffs between the states had the effect of producing a great and relatively self-sufficient economy. While the beneficent fruits of this arrangement are obvious, it is also true that our very success in this direction made possible and encouraged a policy of isolation vis-à-vis the rest of the world.

There is also a parallel between economic relations and political relations. In the centuries which comprise modern times, there has come a pronounced movement toward the establishment of great nations in the place of smaller duchies, principalities, and other small units. While this movement has had many advantages for peaceful and orderly life within each of these nations, there is no evidence that it has contributed to the establishment of peaceful relations between the national groups. It might indeed be easier to establish a genuine international organization if we had hundreds or thousands of little sovereignties than the smaller number of large national states.

These remarks are not intended as a condemnation of regionalism, a name which has been applied to this movement toward regional trade areas, but merely to sound a note of warning that regionalism holds dangers as well as advantages and that it may call for even higher levels of statesmanship to bring about peaceful and helpful relations between the resulting large groups than between such small units as would be almost forced, by economic necessity, to merge their interests. The hope that such a broad view will be taken by the large units is sup-

ported by the fact that at the present time the United States, which, as we have said, is the world's largest customs union, is finally taking the lead for an even broader organization of the trade of the world.

## GOVERNMENT CONTROLS OF TRADE

Even more serious than the general obstacles to trade, such as are represented by the ordinary nondiscriminatory tariff, have been certain other devices and policies employed by governments to engineer and direct trade in specific ways designed to advance national interests. One of these policies is bilateralism. It is a policy of buying from those people who buy from you. At best, it is a crude device for bringing about some necessary exchanges of goods when the general fabric of international trade has broken down. At worst, it is a method of exploiting other countries and of using trade as a preparation for war or for the effectuating of hostile policies toward other countries. The weakness of this policy in its purely economic phase can be seen if we try to imagine the limitations that would be placed upon trade and industry in our own country by a similar policy; we will also get some notion of the hampering effect which such a policy has on international trade. If the people and industries of Chicago, for example, undertook to restrict their purchases from Detroit and other communities of the country to the amounts which each of those communities separately took of Chicago products, it is clear that a high degree of territorial division of labor and its resulting productivity would be impossible. We must have, in order to realize our potentialities in the international field, as well as in the domestic field, the possibility of A selling to B, B selling to C, and C selling to A, and so on, with more letters than there are in the alphabet. We will not attain a tolerable degree of international division of labor by the device of bilateralism: genuine multilateral trade is essential.

Even the more modest attempt to favor those who buy from us is subject only in lesser degree to the same objections. Adam Smith commented, in dealing with the bilateralism of his own time, that it was a policy which appealed to small traders. The

small merchant, he said, is likely to try to buy directly from his own customers and to expect such favorable treatment from those from whom he buys. But, he continued, that is not the policy of large merchants. They follow the more enlightened policy of buying in the cheapest markets and selling in the dearest markets; and, he added, "the sneaking practices" of small traders have been exalted into the policy of a great empire. That policy has as little place today in a world scheme of things in which freedom of action is emphasized as it had in 1776.

A second device for the national control of trade is the control of foreign exchange. If a country is to purchase goods from other countries, it must obtain control over the purchasing power of that foreign country. This control is normally obtained by exporting goods, by borrowing from that country, and by other means. If now a government wishes to control the imports into its borders, either by determining the specific countries from which they shall be bought or even the specific firms, it can do so by obtaining control of all the foreign purchasing power which its nationals have succeeded in securing. It will be seen, then, that this device is the most powerful one that can be used, for while the tariff merely discourages certain classes of imports and while other devices commonly have a general effect upon the direction of trade, this device can be specific and complete. In its widespread use, control of foreign exchange is a relatively new device and reflects, incidentally, the increased power of the governments and their control over the private affairs of their citizens. The reduction or abolition of this type of control must play an important part in any program designed to reestablish orderly and relatively free trade in the world.

A third method of state control is through the influence which the government can exert over the *rate* of exchange between their currency and that of other countries. In trade between two countries businessmen have to consider relative prices in the two countries, each expressed in terms of its own national currency and the rate of exchange between the countries. Thus, for example, the ability of an American exporter to sell typewriters to an English importer will depend in large

part upon the dollar price of typewriters here, the pound price of typewriters there, and how much those pounds will be worth in terms of dollars. In short, the relevant factors are the prices in the two countries and the exchange rate.

Likewise the ability of the English exporter to sell woolen goods here will be affected by the relative prices and by the number of pounds he can get for his dollar sales (or by the price the American buyer will have to pay if the goods are priced in pounds). Now if the English traders are having difficulty in selling here, there will be two things they can do: (1) lower their prices in England, or (2) readjust the exchange rate so that it will be easier for Americans to secure pounds for their dollars. This means depreciating the pound so that it will cost Americans a smaller amount in dollars and cents.

During the nineteenth century and up to 1914, if one country was at a disadvantage in exporting (as indicated by an excess of imports over exports), adjustments were made almost entirely in terms of prices and costs. Temporary maladjustment would be offset by credit adjustment, and more sustained maladjustment by an outward flow of gold (to pay for the excess of imports). This loss of gold affected reserves and tended to restrict credit, and thus it acted to depress internal prices and costs. The rate of exchange between one currency and another varied only within narrow limits set by the cost of shipping gold. Since the abandonment of the gold standard and the free flow of gold, the adjustments are no longer even approximately automatic. They have become the subjects of conscious decisions and government policy. As between the two remedies for declining exports or excessively large imports, national governments will usually dislike the solution of reducing prices. The resistance to it is readily understood, for it would involve the whole fabric of costs and prices (including wages which may be supported by strong labor union pressures). Especially when domestic trade and employment are at low levels, such a deflationary program is highly distasteful and perhaps impossible. The alternative remedy is, therefore, frequently favored, namely, to depress the value of the country's currency in terms of the currencies of other countries. It is less painful to depress your

own currency in international markets than to lower your domestic price and wage level.

But this remedy sets up repercussions, for the other countries are also affected, and especially so if they too are suffering from unemployment. This fact may well lead to an exchange depreciation which nullifies, or more than nullifies, the efforts of the first country. These countries may add other obstacles, such as higher tariffs and import quotas, to redress their balance through reducing imports. Thus a competitive race in encouraging exports and obstructing imports is set up which, of course, is suicidal when viewed generally for the simple reason that, for all the countries together, the exports and the imports are the same thing.

To avoid a progressive blocking of trade requires that a balance be sought in which two-way trade will be possible, and this requires a compromising of interests. The dangers of progressive deterioration of trade and finance, through unilateral action by a number of countries each trying to save itself by making it more difficult for others to save themselves, have become so apparent and serious as to demand joint action by the nations. Such joint action, however, must allow for some flexibility of exchange rates and this is particularly necessary because of the increasing rigidity of prices and governmental policies designed to maintain them. The problem, therefore, is, through international agreements and machinery, to permit a necessary degree of flexibility and at the same time to prevent the irresponsible and unilateral changes in rates which would lead to a disastrous competitive race for still further depreciation. Steps are being taken through the International Monetary Fund to accomplish this end. Only a small beginning has been made, and we must still say that this device is a poor substitute for the automatic adjustments which the free flow of trade and the gold standard provided. Space does not permit a discussion of these and the many other policies of national states in particular. Enough perhaps has been said to suggest that, when interferences with the free flow of commerce are made in one direction, they require further interferences and manipulation in an effort to attain even a tolerable degree of international division of labor.

The interests of American businessmen in these technical questions are very real. An American manufacturer, for example, who is contemplating an expansion of his market abroad and who is considering an expansion of his own plant to take care of that business will be deterred by uncertainties. There is the uncertainty of the price that he will realize on the sale of his goods; or, if the practice is only to quote in terms of dollars, there is the uncertainty of future sales when the competitive position of traders in this country is greatly affected by exchange rates. If the manufacturer is considering the possibility of building a branch factory in another country, there will be the uncertainties of how much it will cost to build this factory even if materials and equipment are shipped from this country, the uncertainty of the dollar value of his returns, and even the very real uncertainty of his ever getting returns back into this country. To capitalize, therefore, upon the great potentialities that are supplied by foreign markets and the development of backward countries requires that the obstacles to trade and the great mass of artificial hazards which have been added to the normal uncertainties of business ventures should be reduced. In the efforts being made in this direction American businessmen have a very real stake.

## ECONOMIC RECONSTRUCTION AND LOANS

When trade and economic relations were established between nations on a liberal basis, such as was approximated in the world during the nineteenth century, and especially in its latter half, there was a tendency for capital to flow from those countries, in which it was relatively plentiful, into those countries where it was more needed. This movement of capital was made on a basis of private business incentives, particularly in an effort to obtain the best rates of interest or the best profits. The industrial development in the United States, for example, was fostered by the flow of funds from Europe into the new land on this basis. Such forces, directing and channeling the flow of funds and correspondingly the flow of trade, are still greatly to be desired. However, when widespread destruction has been caused by wars and when human suffering is so rampant as to shock the conscience of the world, the extension of international aid on other

grounds is called for, and it is deemed necessary for one national state to extend aid directly to and through other national states. When this device is introduced, a number of questions of policy arise which it was not necessary to face under a regime of private direction of the flow of funds. First, the motivation will obviously be different. A powerful and commendable motive is the sheer humanitarian consideration of relief. Second, there is the desire to reestablish the economies of countries with whom we have traded in the past and with whom we must hope in the future to conduct profitable and mutually advantageous trade. A third consideration is that these matters of relief and reconstruction have international political implications. It is thus clear that the advancing of funds is prompted only in part by economic considerations. In so far, however, as these funds are designed to advance the expansion of enterprise, it should be our policy to place our aid to other countries as soon, and to as great a degree, as possible on a self-respecting, two-way basis.

The making of gifts that will in the long run benefit the receiver (to say nothing of the giver) is fraught with difficulties. Even more dangerous is the making of loans that involves generosity to the extent that neither party is quite sure whether repayment is really contemplated. For both in international affairs and between individuals, there are few more fruitful sources of dissension and bitterness. The traders' relationship, under which the parties feel that a fair deal has been made, is likely to contribute to self-respect and to mutual respect. Such international dealings should be based, as far as possible and as soon as possible, upon an intelligent regard for our own interests and upon anticipation of the meeting of obligations by honorable men, and preferably by private citizens.

### POLITICAL DIFFICULTY OF SECURING LIBERAL TRADE POLICIES

The problem of attaining and maintaining mutually beneficial trade relations is complicated by the way in which the policies of liberalizing trade relations and particularly of reducing tariffs have been politically presented in this country

and by the existence of certain widespread views of questionable validity. We turn to a brief examination of these obstacles and to the adoption of policies favorable to the expansion of trade.

On the tariff question, the greatest divergence, to be found on any great economic issue, has existed between the views of professional economists and the policies of government. This divergence has persisted for over a hundred and fifty years—the economists consistently supporting the cause of free trade and the legislators, presumably reflecting the view of voters, remaining consistently protectionist. A reason for this divergence lies in the fact that the case for protection is practically always presented from the point of view of producers, while the case for free trade has usually been presented from the point of view of consumers. The arguments of the protectionists appear, therefore, to be highly irrelevant to the arguments of the free traders, and vice versa. Furthermore, the irrelevance is not abolished, in the popular opinion, by pointing out that producers are also consumers. It is a commonly observed fact that people are much more aware of their interests as producers than of their interests as consumers. Partly because of this mental trait, the free trader has been doomed to defeat.

Despite the fact that consumption is the end of the economic process and production is but a means to it, it is not entirely unreasonable that people should, as a practical matter, think first of their interests as producers and earners of income rather than as spenders of that income; at any rate, people are going to continue to think that way. The free-trade argument, if it is to be accepted in a democracy, must, therefore, be advanced from the point of view of producers, and a strong case can be made from that point of view. It is true that the immediate effect of encouraging international or interregional trade is to help some producers and to injure others. Trade is a two-way process. If we export products of one kind, we must import products of another kind; and the immediate effect of those imports will be, or will appear to be, disadvantageous to the home producers of the imported goods. Considering only the immediate and perhaps superficial, but nonetheless politically important, interests of producers in this country, we find that these producers

fall into three groups. First, those industries in which we have a natural or acquired advantage. This group would include all those industries in which we are now exporters plus some industries in which we could export if the conditions of world trade were freer or if we were willing to accept imports in exchange. Second, the group of industries in which we suffer a comparative disadvantage in competition with other countries. These are the industries which exist by or rely heavily upon the protection afforded by import duties. But there is a third group, and it is the largest: the industries in which the goods or services produced would not, by their nature, enter into international trade. These include the railroads and other internal transportation agencies, domestic merchandising, building trades and industries, and professional, public, and personal services. The people in these lines have no direct interest in the controversy as producers, but they have an important interest as consumers.

To secure action for reducing the obstacles to trade it is necessary in all countries for that large group of producers in the first category to take a positive stand in their own interest as producers and as earners of income. They should be able to enlist the support of the producers of the essentially domestic industries on the basis of the interest of that group as consumers.

In our own country, automobile manufacturing provides one of the clearest examples of an industry in the effective first category. The employers and the workers in that industry can derive no possible benefit from protection, for the very fact that their products are exported and are, therefore, sold in free markets in which they can have no artificial advantage—in fact, often overcome serious obstacles imposed by other countries—proves that the employers and workers in that industry do not need to fear the competition of foreigners in their own market. But even when this fact is recognized, the representatives of this industry have been inclined to take a neutral attitude. This would seem to be unwarranted, for their interests are not neutral. The restrictions of the imports of other articles place a direct check upon the possibilities of selling exported automobiles. In effect, a protective tariff restricts the export of products

of this kind in an effort to support less effective industries.

We have as a nation been too acquiescent in meeting the demands of ineffective industries that wish to remain in existence and too indifferent to the possibilities of expansion of our more effective industries. Indeed, it seems to be almost a national characteristic to be more concerned with preserving inefficiency than in encouraging efficiency. A profitable retail store offering wholesome products at low prices is a much more likely target for taxes or government suspicion than the store which is chronically on the verge of bankruptcy although charging high prices and giving poor service. This is a dangerous perversion of natural selection.

The interests of workers in the effective industries are at stake as much as the interests of management. For from the point of view of employment, advancement, and security, it is better to be employed in an expanding industry. Here, then, is one of those points of mutual interest of workers and management which, if combined in the effective industries, should enable the expansionist possibilities to get their due attention—and in a way that would carry political influence.

Britain's switch to free trade in the last century was made when the manufacturers of Britain, and the workers, notably in the textile industry, came to realize the interest which they had in exports and the limitations which were placed upon the realization of those interests by the prevailing import duties on agricultural products. It was the pressure brought to bear by those manufacturers and those associated with the export industries that led to the adoption of a policy which made possible the great expansion of that country and the raising of its standard of living in the nineteenth century. When the representatives of the more effective industries realize their positive interest in this question, we may expect like action in the industrial countries of the world today.

### RELATIONS BETWEEN FREE TRADE AND CONTROLLED ECONOMIES

Another difficulty envisaged in re-establishing market forces as the controller of world trade is that of conducting trade be-

tween free and controlled economies. In trade between two countries, one of which is represented by individual businessmen and firms competing among themselves and the other by the national state, the former suffers an apparent disadvantage. The danger is that, when faced by this situation, the free-market country will seek a solution by forming cartels to fight fire with fire. One has to agree too, in principle, that "free trade is a nearly meaningless conception where collectivism (or totalitarianism) is present."[6] We should add, of course, "to the degree that it is present or that it dominates the scene." This provision is necessary, for the monopolistic power of the national state, either as buyer or seller, is limited by the presence of other buyers or sellers—even if those others are also state monopolies but especially if they are not.

At the present time, the principal exponent of state trading is Russia. From a purely economic point of view, the mere control of trade by the state would not make impossible the conduct of relatively free trade in the world at large; most of the goods which Russia buys from other countries are not bought by her alone, and the prices she pays must, therefore, conform to those set in free markets, assuming the rest of the world wishes to maintain such markets. On the other hand, few of her exports are obtainable only from Russia. She is, therefore, as to most goods, merely one buyer or seller, although perhaps in the case of some products an important one. This suggests another point—that Russia in total is not (at least has not been) by global standards an important trading nation. In 1938, for example, Russia took but 1.1 per cent of the total world's imports, and she supplied but 1.2 per cent of the world's exports. Nor was her role in world trade increasing, for the proportion of imports in 1928 was 1.4 per cent and of exports 1.3 per cent.[7] Under the old regime (1913) her share in world exports was 4.2 per cent.[8] These facts, of course, do not minimize the importance of Russia as a world power, either in a military or economic

[6] Henry Simons, in *Postwar Economic Problems*, edited by Seymour E. Harris (New York: McGraw-Hill Book Co., 1943), p. 743.

[7] League of Nations, *Net-work of World Trade*, Economic Intelligence Section (Geneva, 1942), pp. 17–18.

[8] League of Nations, *Memorandum on Balance of Payments* (Geneva, 1926), p. 132.

sense. But it may be anticipated that her power in the latter sense will not impinge so directly or in such a degree upon the outside world as will that of countries of a more highly specialized nature. Her economic position is like that of the United States in that her producing power is great and out of all proportion to her world trade.

This view of the relation of Russia as a trading country to the rest of the world does not mean that political conflicts between that country and the West may not have important effects upon the economic destinies of the world. It merely means that there is no necessary economic reason for such conflict. The problem of economic policy for the free market countries is mainly to avoid a piecemeal extension of nationalistic controls by and among themselves. For, from a purely economic point of view, it is along that line that greater dangers lie than in the existence of one or a few controlled economies.

## EFFECT OF INDUSTRIALIZATION OF BACKWARD COUNTRIES

An attitude of defeatism or indifference as to the extension of international trade is supported by the view that the tendency for most countries to become industrialized will make them more self-sufficient and that they will reduce purchases from us and the outside world in general. It is true that, as an agricultural country develops industries, it places itself in a position in which it can, in case of military or other necessity, be more nearly self-supporting; and also, if it wishes to indulge its protectionist groups, it can adopt such a policy without disaster. But it is not true that an increased industrialization will, in the absence of restrictions, lead to a decline in the trade of that country.

The fact is that as a country develops industries it becomes a better market for the other industrial countries. The explanation of this paradox lies in the fact that the products of industrial countries find their best markets in countries where a reasonably high purchasing power exists and is well diffused. Such conditions are found in some agricultural countries, such as Australia, New Zealand, and Canada, but they are more common in the

industrial countries. Just as an industrial area like that surrounding Detroit finds rich markets for its automobiles in other industrial areas of this country, so the leading industrial countries, in spite of tariff obstacles, find rich markets in the other industrial countries. There are many evidences of this fact in international, as well as in domestic, trade. One is the prominent place which the leading industrial countries have held as customers of one another.

Even in the immediate prewar period, this mutual dependence was marked as is shown by the fact that the best foreign customers of France were Belgium, the United Kingdom, Germany, and the United States; the best customers of Germany were the Netherlands, the United Kingdom, Italy, Sweden, France, Czechoslovakia, and the United States; and the best customers of the United States were the United Kingdom, Canada, Japan, France, and Germany.[9] The intertrade was even more pronounced prior to the extreme nationalistic policies of the thirties and suggests that the potentialities of industrial countries as markets for other industrial countries are greater than the actual flow of such trade over the recent serious barriers would indicate. Such obstacles come largely from governmental policies and not from any natural cost-price relations which would exclude the products of industrial countries from the markets of other industrial countries.

The basic fact is simply that the aggregate of national income and the distribution of it which are favored by industrialization provide the best demand for industrial goods and that, as that demand is increased, it becomes more discriminating and specialized and thus the industrial country provides a market for manufactured goods from other countries as well as for such goods from its own industries. A more general recognition of these facts should have two desirable effects on the attitudes and policies of leading countries. First, their rivalry for the markets of backward countries should, at least, be tempered by an appreciation of the larger markets which they can offer to one another. Second, it should banish any fear of the indus-

[9] As to Germany and France, *Foreign Commerce Year Book* (1939), pp. 39 and 54; as to the United States, *Statistical Abstract of the U.S.* (1940), pp. 508 ff.

trialization of backward countries. As a practical matter, for example, an industrial country cannot hope to sell its mechanical household appliances in really substantial amounts to backward countries until the productivity of those countries and the purchasing power of their masses is advanced; and that advance awaits industrialization. The trend to industrialization will continue the world over; it should not be feared but welcomed, not only for the improved standards of living which it promises to bring to the countries directly affected, but for the expansionist possibilities which it presents to the present industrial countries.

## CONFLICT OF NATIONALISM AND INDUSTRIALISM

Any determination of national policy in relation to international affairs, especially when undertaken by a country which has such a preponderant role in international affairs as has the United States, should be made in the light of the broadest possible considerations and in recognition of fundamental world trends. There are, of course, a number of ways of describing these world trends, but one that is particularly significant for this purpose is to observe that modern times (by which we mean the past few centuries) have been dominated by two developments. One is the rise of nationalism and its modern sequel of "statism." The early phase of this movement was the emergence of nations as the significant political units to displace the many small principalities, duchies, and other units which grew out of feudalism; the later stage has been the increasing role of these new nations in social and economic affairs. The other great development has been industrialization.

These two movements, in some respects, are consistent with and have supported one another, and in other respects they have been in conflict. Thus the development of a reasonably strong authority, able to maintain orderly processes and support property rights, was essential to the growth of industries. Also, the extension of the field of political control over somewhat larger areas was conducive to the free exchange of goods, at least within those areas, which is essential to even a moderate development of industry.

On the other hand, the national state, particularly in its later developments, has attempted the role of controlling the conditions of industry and determining to an increasing extent the income shares of the various elements in the economy. But this latter objective is difficult to attain if the economy is closely dependent upon the economies of other countries. If a particular country—prewar Germany, for example—desired to determine the level of wages, hours of work, rates of interest, and other vital matters, it would be hampered by a necessity of selling a considerable part of its product in foreign markets. For when the country went into the foreign market, it would find that its authority over prices ceased and that it must, if it were to sell, conform to the prices set by free market forces or to prices set by some other state which was perhaps trying to follow the same policy. On the other hand, if the country did not export its products, it would be unable to secure raw materials which lay outside its national borders. Faced by these problems, it would strive to approximate a self-contained economy which it could control.

This solution, however, runs counter to the logic of modern industrialism, for that logic calls for very large producing units and a high degree of specialization. The counterpart of these features of production is a wide market for goods and an access to raw materials throughout the world. Thus we have a fundamental conflict between statism and industry, the former looking to self-containment and the latter to wide markets. A solution of the dilemma might be found in a deliberate acceptance of a very modified industrial state in which effectiveness of production (and, consequently, of incomes) would be sacrificed. This, however, is not a feasible solution, for the very existence of national states today depends upon an ability to defend one's borders and resources, and that power of defense rests primarily upon the productive powers of the country.

Since that is not a feasible solution, the other logical possibility will suggest itself, namely, to so increase the area over which the national state holds sovereignty or exerts control, as to make it include a larger market and more essential raw materials. The conflict between these two forces would be solved when one national state became supreme throughout the world.

Such thoughts no doubt have passed through the minds of certain peoples where the spirits of nationalism and industrialization have both been highly developed. But the outcome of the recent war strongly suggests that a solution along this line is impossible and that efforts to meet the problem in this way can only result in economic waste and suffering and the ultimate destruction of such overweening national ambitions.

What, then, is the solution? Is there any way in which the demands of nationalism and industrialism can be reconciled? It would seem clear that a complete satisfaction of the requirements of both is impossible, and, therefore, a compromise is required to secure the economic well-being of the world and its future peace. In this compromise the logic of the machine is so compelling that political forms and aspirations must conform thereto; and this means, in terms of national policies, that trade must be allowed to flow across international boundaries and that extreme identification of the political unit and the economic unit must be given up; or, if that is impossible, then the other solution must be the growth of a new and even larger political sovereignty, perhaps in the form of a real superstate.

As between these policies, much less disturbance and violation of national sentiments and aspirations will be done by the former solution. Furthermore, to accept it calls simply for a recognition of the advantages to all in territorial division of labor, and the acceptance of the truth, which liberals from the time of Adam Smith have emphasized, namely, that the prosperity of each country is dependent upon the prosperity of all other countries and that prosperity is an indivisible thing and is not to be gained by a policy of "beggar-my neighbor." The statement of David Hume about 1760 is the beginning of wisdom on the economic relation of nations: "Not only as a man but as a British subject I pray for the flourishing commerce of Germany, Spain, Italy and even France itself." [10]

## ROLE OF THE UNITED STATES IN WORLD TRADE

We introduced this subject of international trade with some observations on the importance of foreign trade to the United

[10] The essay "Jealousy of Trade" in *Hume's Essays, Moral, Political and Literary*, Green and Gross (London, 1898), Vol. I, p. 348.

States. We tried to indicate the degree of its importance by showing the extent to which exports contributed to our national income, the extent to which our national income was spent upon imports, and how the effects of those exports and imports ramified throughout our economy. But it is clear that the United States has an interest in the healthy state of trade in the world which far transcends these direct effects. It is now clear that, for better or for worse, we are a part of the world and that any factors which powerfully influence the state of well-being of the world society may have life-and-death effects upon us. Particularly we cannot escape the effects of forces so powerful as those of trade and capital movements which contribute to the economic and social well-being of the world as a whole. It is fitting, therefore, that in closing this discussion we should look at the effect which our trade and trading policies may have not upon our economy directly but upon the rest of the world and, therefore, upon us indirectly.

Despite the object lesson provided by World War II, that influence is not yet fully appreciated by all Americans. Some indication of the position of the United States is provided by looking at the national income figures of the different countries. It is commonly recognized that our national income is the largest in the world, but how much larger is not always understood. The fact is that in viewing national incomes one can well compare the United States on one side with the rest of the world on the other. If we put on one side the national income of the United States in the prewar years and on the other side the total national incomes of the other leading countries—beginning with Great Britain and going down the list through Germany, France, Japan, Italy, and so on—we must combine the national incomes of over a dozen of the leading powers to arrive at a total which is as large as our own national income.[11] The relative preponderance of the United States is even greater today.

[11] A high degree of precision is not possible because data for any one year are not generally obtainable. The statements made herein purposely err on the conservative side. Cf. Millis and Montgomery, *Labor's Progress and Some Basic Labor Problems* (New York: McGraw-Hill Book Co., Inc., 1938), p. 41; Carl Snyder, *Capitalism the Creator* (New York: Macmillan Co., 1940), p. 35; Leven, Moulton, and Warburton, *America's Capacity to Consume* (Washington, D.C.: Brookings Institution, 1934), p. 172.

This overwhelming position is also suggested by thinking of the "national" incomes of our individual states in comparison with those of other nations. Even the prewar national income of the United Kingdom was only slightly larger than the income for the state of New York; and the national income of prewar France was substantially smaller than that of New York. Precise figures are not obtainable and are not needed; but merely in order of magnitude, Canada should be compared with the state of Pennsylvania, Japan with Ohio or Michigan, Argentina with Texas, and Peru with North Dakota. If our forty-eight states were regarded as so many nations, many of them would rank among the important world powers from the point of view of economic productiveness.[12] It seems clear that the combination of these forty-eight "powers" must inevitably have a tremendous influence upon the economic well-being and peace of the world. It becomes clear that a policy of economic isolation is out of the question.

Even if we look at our exports and imports and admit that from the point of view of the American economy they play a relatively small role, it is still clear that from the point of view of the world those exports and imports are highly significant. The United States in 1938 provided 14 per cent of the total exports of the world, and this was a larger proportion than that provided by any other nation. The second in rank was the United Kingdom, with 12 per cent; and no one has ever questioned the important role of the United Kingdom in international trade. Likewise, if we think of the total imports of all the countries in the world, the United States took 13 per cent of all those imports, the United Kingdom took some 12 per cent, Germany took 9 per cent, France 4 per cent, Japan 4 per cent, Italy 2 per cent, and Russia 1.4 per cent.[13]

These relationships show clearly why foreign countries look

---

[12] It would be dangerous to draw any conclusions as to military power from these facts. The ability to fight depends, of course, upon many factors other than economic productivity, e.g., the sheer weight of numbers of fighting men, a low customary standard of living relative to potential production, geographic area and location, morale, political forms, and others.

[13] U.S. Department of Commerce, *Foreign Commerce Year Book* (Washington, D.C., 1939), p. 316.

with deep concern to the international trade policies of the United States. The making of a tariff in this country, which may appear to us to be a purely domestic question and which may be treated as such, does, in fact, have a tremendous significance for the standards of living and economic health of other countries—and not merely of backward countries but of some great powers.

The tremendous economic power which this country has can be exerted in ways that will affect far more than the international exchange of goods, important as that may be. Its effects will be great upon forms of government, and from these trends in governmental and social forms the United States cannot isolate itself. It is hardly necessary to argue here, although it cannot be emphasized too often, that there are close ties between economic institutions and political forms and that, as far as we can see, a democratic form of government is most consonant with freedom of enterprise in economic matters. If, then, the United States forms its specific economic policies consistently with its great tradition of economic and political freedom and does so successfully, it will provide the greatest force for the continuation of the democratic form of society and government throughout the world.

The traditional position of the United States up to recent years on matters of international trade has been largely one of protectionism and economic isolation. In view of our high degree of self-sufficiency and, in earlier years, the expansion of our industries, in competition with that of countries who were better supplied with capital and who had started upon that program earlier, this policy was understandable even if not defensible. After, and partly as a result of, the first World War, however, the United States emerged in an entirely different position. We had become the chief creditor country of the world, and our industry in most lines was established beyond any reasonable need of protection. But our national policies lagged seriously behind the economic facts. While we had become the leading economic power of the world, it seems fair to say that in our international economic policies we did not live up to the standards which that position implied. Finally, as a result of the sec-

ond World War and its disastrous consequences for the economies of many countries, the position of economic leadership was virtually thrust upon this country. There is evidence that we are now finally assuming the role which those facts imply. From the position of a leading protectionist country, we are now taking the lead in international negotiations for freeing the world of the many incumbrances to the conduct of trade. Specifically, we have taken the lead in the reduction of tariffs and have reduced our rates to relatively low levels. We are using our influence to lead others along the same path. The parallel between the role which this country is now playing and apparently must play in the future and that which Great Britain played during the nineteenth century is apparent. The time may come when such leadership by a particular country will not be needed, but it is significant that in all ages of the past, at least when tolerable conditions of order and stability existed, there was one power which did boldly assume the leadership and which formed the nucleus for the law-abiding and peaceful forces of the world. The challenge to the people of this country is whether that role will be accepted and utilized to the advancement of trade, the rising standard of living of the world, and the maintenance of peace or whether we shall again, as we did after the first World War, attempt to deny the responsibilities which, for better or for worse, have been placed upon us.

# Part III

## SYNTHESIS

# 21

## *THE PHILOSOPHY OF LIBERALISM*

THE purpose of this chapter is to present a generalized statement of the point of view which has been partially revealed by the various propositions and proposals in our previous chapters. We therefore undertake a brief survey of the road over which we have traveled.

### SUMMARY OF THE ARGUMENT

Our discussion has progressed along the following lines. The economic well-being of a society depends upon the production of that society. That production depends chiefly upon how much the members of the society work and how effectively they work. Of these two factors, effectiveness of work appears to be the more important determinant. That effectiveness can be expressed in terms of man-hour productivity, that is to say, the amount of output per hour for that part of the population engaging in productive work. Effectiveness of work rests in part upon the spirit and intelligence of the workers but, in modern society, even more upon the nonlabor factors, such as progress of science and invention, supply of capital, quantity and quality of management, number of innovators and their energy, imagination, and daring, and the supply of initiative-taking business enterprise.

For an adequate supply of these required factors, there must be incentives which will appeal to the persons concerned and, particularly, to the managers, investors, and enterprisers. In any kind of society, these incentives must be such as will appeal to the aspirations of individuals. These aspirations will take a number of forms, the variety being limited only by the extremely varied interests of individual human beings. To secure the maximum of these creative forces requires, therefore, maximum opportunities for individuals to seek ends that they individually

consider important and rewards for a successful prosecution of those opportunities that are commensurate with the risks and the efforts involved. Therefore, to attain a productive and expanding economy requires, as an ideal, equal opportunities and *highly unequal rewards*. An approach to equality of opportunities is required because only in that way will the potential abilities and creative energies of a society be most extensively utilized. The rewards must be highly unequal because the risks and efforts involved are themselves highly unequal.

Moreover, for the continuation of a high level of production, at least under a capitalistic economy, we must have continuous expansion because, as we have argued, a capitalistic society cannot remain static; it will either go forward or go backward. A requirement, therefore, for maintaining a high level of production and a high standard of living is a dynamic economy which must rely heavily upon the individual incentives just mentioned and, particularly, the incentives to enterprise.

The providing of these incentives requires primarily the maintenance of an environment in which the natural energies and ambitions of individuals can be released rather than that the society directly supply and regulate these incentives. The problem, therefore, of maintaining the dynamic economy envisaged is one of a favorable environment, that is to say, a "climate" favorable to the expansion of the energies of the members in the society.

There are a number of ways in which public policy can affect this environment and thus encourage or discourage these incentives. The chief requirement for a public policy directed to their encouragement, particularly in a democracy, is the recognition of the mutuality of interests of the several economic groups. Such a recognition is particularly required as a basis for public policy which aims at preserving incentives for those minority groups whose leadership is essential to the well-being of all classes. Important among the aspects of public policy which have a bearing upon incentives is taxation. In this area of policy, the most important requirement is a limitation upon the aggregate of taxes. The levying of taxes has the effect of reducing the funds, freely disposable by individuals and freely

obtainable as rewards, for constructive effort. In view of the fact, however, that the aggregate of taxes in all modern societies is large and, despite all reasonable efforts toward economy, must remain large, a most promising line of reform is in the direction of so adjusting the tax burden to the whole community as to create the least practical obstacle to the expansion of production. In general, this means that taxes should, as nearly as possible, be neutral in their effect upon the direction of the energies of the people.

Another way in which public policy profoundly affects the environment is in protecting the competitive character of the society. It is our view that competition must, in a free society, be the chief regulator but, at the same time, that competition will not be self-perpetuating. There are strong incentives for individuals in all walks of life to co-operate with, that is, combine with, others in their own economic category to improve their rewards at the expense of the rest of the society. A community which believes in the efficacy of competition must, therefore, police itself to insure the observance in practice of the principle which it approves in general.

Closely allied to the preservation of competition is the removal of artificial barriers to the free flow of labor, capital, managerial services, and enterprise within the area whose economic well-being is taken as the objective. Practically today, this area means the nation. This mobility should exist not merely between the various parts of the country but between the different fields of employment and investment. Likewise, it should be the responsibility of the central authority to prevent the erection of obstacles to the free movement of goods—or, putting it positively, to insure the maximum extension of the market in a space sense. This requires the abolition or reduction of trade barriers both within the country and between the country and other parts of the world. Analogous also to the preservation and advancement of mobility of productive factors and goods is the free movement of prices of particular things and services in response to the free market forces of supply and demand. For a private enterprise system is a price system, and it can effectively function only if prices are allowed to perform

their services of regulating production, allocating resources, and rationing goods.

There are also certain more positive functions of government in a free system. These involve the preservation of law and order, the enforcement of contracts, the protection of property rights, and the maintenance of other basic economic institutions which collectively provide the setting within which business is conducted. Closely allied to these functions, and a necessary part of public policy, is the establishment or recognition of standards of weights and measures and also the maintenance of a stable value of the monetary unit which, in effect, means exerting government influence for the stabilization of the price level, although not of individual prices.

Effectiveness of production in a country depends to a great extent upon invention, and recently invention has come to depend increasingly upon industrial research. This, in turn, if it is to yield its greatest potential fruits, must rely more and more upon basic science. It is believed that invention and industrial research can largely be provided as a result of the normal individual incentives, economic and otherwise. But the adequate development of basic science, since it does not yield the same individualized rewards, must be supported to a large extent by organized society through one or another of its agencies.

These policies no doubt do not encompass all the requirements of the favorable environment, but they are believed to be basic, and their mention is sufficient to suggest a line of demarcation between those things that can best be left to the individual and spontaneous efforts of the people and those that must be provided by public policy. In other words, these policies suggest the areas in which society, in its organized form, must function in order to free the energies of its individual members for productive activity.

## NEED FOR A PHILOSOPHY

But it is not adequate to suggest a pattern of thought merely by its individual parts. We should, in addition, attempt a more generalized statement into which the specific propositions and proposals will fall. Such a generalized statement can, I hope

without pretension, be called a philosophy. There is a tendency in recent times to disparage and to neglect general philosophies in favor of the view that each question should be settled on its own merits. But this position is untenable, for a person really cannot judge the merits of a particular proposal unless he has first determined what his ends and basic objectives are. Moreover, those who take pride in having no philosophy are thereby revealing a philosophy; for the implication is that there are no basic truths or discernible general ends, and that view itself is a negative type of philosophy, a kind of nihilism.

This attitude of dealing with the problems of the moment without reference to a more general philosophy has characterized the writings of some of the best minds of this generation. Even to some very influential economists, the problems facing the world are apparently to be dealt with on a temporary basis, and questions of the ultimate or long-run effects are disposed of by such cynical comment as "in the long run we will all be dead." Whatever the shortcomings of the classical economists of the eighteenth and nineteenth centuries and of their successors, the neoclassicists, they at least took into account the effects of policies upon all nations and upon future generations and, in these respects, showed a broader and more responsible attitude than have many of our publicists of the present time. It was characteristic, indeed, of the late eighteenth and early nineteenth centuries that men generally dealt with public affairs on a high and generalized plane, as will be apparent to anyone who contrasts the discussions which received popular attention in those days, for example, the *Federalist Papers*, with the political discussions of our own day.

Particularly among our self-styled liberals is there characteristically a failure to envisage general ends or objectives to which their individual proposals would lead. To meet particular evils, real or imagined, these "liberals" propose to strengthen functional groups, such as labor unions and farm blocs and, for the most part, fail to consider the kind of society to which the development of such power units would lead. The very fact that the term "liberalism" has been so radically distorted in these later days from its original meaning is not so

much an evidence of the adoption of a new philosophy as it is a renunciation of any general philosophy at all.

In view of the present state of the world, the results of this continual improvisation are not attractive. We need to remind ourselves of, and to rethink, some of the basic principles upon which a free society rests and to check the wisdom of particular proposals against these bench marks.

Particularly for young people, who are the students of today and who will be the men and women of affairs in the near future, there is needed, not so much answers to the specific questions which have been raised in this study, as a general philosophy and point of view which will enable them to meet the problems of the future. For it is certain that many of the particular questions with which we are concerned today will, in a few years, be as passé as the question of bimetallism and the single standard, which was a major political issue a few decades ago.

Moreover, anyone discussing such currently important questions as some of those in previous pages must have a painful sense that, at this point or that, he has fallen into error. He can, however, take comfort in the fact that such problems must be discussed as they arise and in the recollection that even the great thinkers of our past were often wrong in their diagnosis of current problems. Adam Smith, the founder of systematic political economy, is not studied today for his observations or prognostications on detailed problems. In these he was often in error as, for example, when he grossly underestimated the potentialities of the corporation. But he is justly remembered for his philosophy of economic freedom and his vision of a natural system of liberty which have served as guides to freedom-loving people since his time. Errors may be made in the navigation of a ship, but they may not be too serious if there is a pole star by reference to which they can be corrected. Such a pole star can be provided by a philosophy which each person must make for himself. This is not to say that such a philosophy may not itself change by evolution and growth but that, relatively, its rate of change will be slower than the appearance of new problems and the need for answers to them.

Another reason why it is desirable to formulate a general

social philosophy is that such a general view is needed to supplement the purely economic objectives. At the outset of this study, for example, we took as our objective the improved economic welfare of the people, and to attain this economic end we have largely relied upon economic means. But it is clear that the sum of life cannot be so neatly partitioned that we can sensibly consider one aspect independently of the others. If evidence is needed of this rather obvious fact, it could well be found in the discord within our society and in the fact that our people are probably no closer to the attainment of happiness and peace of mind than they were forty years ago. All this is true despite the fact that great economic progress has been made, both in the total of national income and in the diffusion of that income among all social classes. The concepts of want and poverty change greatly from generation to generation. But measured by the definition of those terms which prevailed forty years ago, this country has come very close to abolishing poverty. That so much progress could have been made and, at the same time, that the broader goal of human happiness and peace could still be so far from realization as it is today, surely indicates that man does not live by bread alone. Even the problem of expanding production which underlies the economic well-being of the people is but a contributing means to larger human ends.

A social philosophy, therefore, which looks to the maximizing of human satisfactions of all kinds must deal with such questions as the relation of individuals to one another and especially the age-old question of the relation of the individual to the group. It must have a point of view as to the relative importance of opportunity, the possibility of individuals realizing their full potentialities, satisfying their creative impulses, and maintaining their self-respect. All these, as well as views on an economic standard of living are encompassed in a social philosophy. The good life cannot be judged merely in terms of the number of motor cars and the supply of central heating and indoor plumbing. Indeed, that much misused term, "the abundant life," is a highly individual thing. It cannot be guaranteed by any form of social organization. But the social organization

can be favorable or unfavorable to its attainment. The problem, then, as far as a social study is concerned, is to provide the "good society." That good society is one which will enable the largest number of people to seek the good life, *as they choose to define it*, most effectively and with as few obstacles as possible.

## RISE OF LIBERALISM

During the eighteenth and nineteenth centuries there arose in England, in certain western European countries, and in the United States a philosophy and, to a degree, a social system, which attempted and, in the opinion of many, gave the closest approach to answers to these fundamental questions. It was the philosophy of liberalism. Like any philosophy, it should be judged by its ideals and its promise rather than exclusively by its actual attainments. It should be regarded as an indication of the road along which progress would lie.

To understand the significance and the meaning of this movement, we should remind ourselves of what had gone before. Throughout most of the known history of mankind, men have been controlled to a high degree. This control has been exercised by tribal chiefs, priests, dictators ("tyrants," as they were then called), kings, emperors, feudal lords, and guilds. Moreover, there was the great mass of customary laws which limited man's freedom of action. Only at rare intervals were considerable groups of individuals relatively free. Such freedom existed for certain classes in the Greek city-states, in Rome at certain periods, and at times of social upheaval when all organization and authority were at a low level. While these periods of relative freedom were few and usually short-lived, they include the most creative periods of man's history. The disorder of Italy, for example, and the relatively weak position of the Italian city-states were concurrent with the Italian Renaissance.

Unfortunately, as these illustrations have suggested, periods of freedom were often periods of disorder and chaos. Indeed, to many it seemed that the concept of freedom and the concept of order were opposed and that men were doomed to have the blessings of the one only at the expense of the other. It was not until well into the modern age that the growth of popular rep-

resentation and popular government, particularly in England, pointed the way out of that dilemma.

With the rise of the great nations in the later Middle Ages and in the early modern period, a new source of power appeared, and that power was exercised vigorously. The development of the spirit of nationalism brought with it patriotism and the fear of or desire for aggression. The growth of modern nations corresponded also with a growth of commerce; and it became apparent in the fifteenth and sixteenth centuries that the power of nations depended greatly upon the treasure, that is, gold, which was produced by trade and which was necessary to maintain armaments and, in other ways, to enhance the prestige of the sovereign state. That being apparently true, it was perhaps inevitable that the rulers of these states should conclude that trade could not be allowed to take its own course but that it must be directed in such ways as to contribute to these nationalistic ends.

The resulting policy was known as "mercantilism." This involved a control of exports and imports which was designed to increase the favorable balance of trade, because such a favorable balance brought gold into the country. Mercantilism also involved the control, indeed, the highly detailed regulation, of production within the country. This latter phase of government regulation reached its peak in France under Colbert, the finance minister of Louis XIV, who laid down minute regulations as to the type of textiles that could be manufactured in each of the communities of France. These regulations went so far as to say that weavers of Rouen should make cloth of a specified number of threads to the inch, whereas those in other communities were to follow patterns specified for them. It seems apparent enough to us today that the growing industry and trade of Europe was hampered and shackled by all of these regulations. (Before we become too complacent about our superior understanding, however, it should be noted that some of our N.R.A. codes of the thirties looked suspiciously like the *reglements* of Colbert.)

Gradually the logic or lack of logic of the situation was borne in upon the people, particularly the trading classes, and even

upon their rulers during the eighteenth century. This growing doubt of the efficacy of regulation and the rising sentiment for freedom were finally expressed in the latter part of the eighteenth century by such writers as David Hume and especially by Adam Smith, in his *Inquiry into the Nature and Causes of the Wealth of Nations*. In this great work, Smith made an eloquent plea for a natural system of liberty and for division of labor which he believed would result from that liberty. He argued that under a system of freedom individuals, in seeking their own ends, would contribute to the welfare of other individuals. This work of Adam Smith's stands as a milestone in the economic and social thinking of men. It does not detract from the importance of the work to recognize that it only expressed the growing feelings of the time; it was indeed that fact that gave the book its great practical influence.

Of course it is not suggested that an utterly new philosophy and, much less, a practical system of economics sprang full-blown from these pioneer works. That was not the case. The liberty envisaged was chiefly on behalf of rising industrial and commercial classes. It is not surprising that that should have been true, for nearly always great general ideas of this kind are applied first to some group whose grievances are expressed and who have the power to correct them. Thus, the beginnings of political freedom may be traced back to the Magna Carta in the thirteenth century, although that document merely granted certain rights to the nobles against the king. But an idea such as that of the rights of individuals against their ruler has a way of spreading, and ultimately it did spread to more and more people in the realm. In the same manner, the lofty sentiments concerning equality of all men expressed in the Declaration of Independence did not, at the outset, include Negro slaves. But there, too, the basic idea ultimately leaped over the barriers of the time. So in this case, the economic freedom of certain classes paved the way for an extension of that ideal to all other classes. Fortunately, the movement for economic freedom was accompanied by the development of popular government and of political and civil liberties. Thus, the dilemma of previous periods of reconciling freedom with order was avoided. Moreover, the

development of freedom in the one area strengthened and hastened the development in other areas. Political liberty was conceived as having two aspects: the limitation upon the power of government and the greater control of that government by the people.

Through a favorable combination of historical forces and circumstances, our own country was born at the time when these ideals of political and economic freedom were riding high. Our Constitution reflected them in the concepts of representative government and limitations upon the powers of government. It will be apparent, then, that the fact the *Wealth of Nations* and the Declaration of Independence both came in the year 1776 is somewhat more than a coincidence. The one expressed the principles of economic freedom and the other expressed the principles of political freedom.

During the nineteenth century, these ideas expanded at a remarkable rate. They excited the minds of statesmen and philosophers alike and gave rise to a great practical program of removing restrictions and to the philosophy of liberalism. This philosophy, emphasizing, as it did, individual liberty and restraints upon the power of private groups and government, is obviously not to be confused with the use of the terms "liberal" and "liberalism" which has become current among popular leaders and in the press in the last decade or two.

Indeed, in many ways the self-styled "liberal" of the present stands at the opposite pole from those of the nineteenth century and from the meaning which we here attach to the term. The contrast could be drawn in many ways. A most obvious one is that the present-day liberal relies to a great extent upon collectivism of one form or another and the use of the power of the state and of private groups to attain desired ends, while the traditional liberal philosophy has sought the minimizing of such powers and the liberating of individuals to seek ends which they themselves consider important. To present a sharp contrast in general terms would be difficult because there has been relatively little effort to define the philosophy of this present-day liberal. It is significant in this connection that in these later days men call themselves liberals, but the term "liberalism" is

less frequently used in this country, implying thereby that it is an appellation assumed by people holding extremely diverse views and agreeing on nothing more than such vague shibboleths as being "forward-looking" and concerned with the "common man." It is interesting to note that in European countries, and particularly among totalitarians, the real traditional meaning of liberalism still holds. Hitler, Mussolini, and Stalin have turned their bitter invective against Western liberalism; and even some of the leaders of the milder, state socialism of England have joined them in their scorn for this nineteenth century ideal. We shall not take more time to elaborate this contrast but ask the reader to bear in mind that we do not attach to the term "liberalism" the meaning which is given to it in most popular usage today. We rather use it in the sense in which it was traditionally used and is still used by social philosophers, both those who defend it and those who hate it.[1]

## ELEMENTS OF LIBERALISM

What, then, is the meaning of liberalism in this traditional sense? As a broad philosophic concept it involves, first, the view that the individual is the end and the center of our world and that human institutions are but means to advance the interests and the development of those individuals. The implication of that concept is that liberty, as a political ideal, is not a means to an end; but, as Lord Acton expressed it, "Liberty is itself the highest political end."

This idea, although it was not unique in the eighteenth and nineteenth centuries, was by no means commonplace, and it never has been universally accepted. It was opposed by the concepts of the organic nature of the state and of society, in which the individual was regarded as a means for strengthening and glorifying those groups. Against this beehive philosophy the

---

[1] For example, among its exponents, William Orton, *The Liberal Tradition* (New Haven, Conn: Yale University Press, 1945); Walter Lippmann, *The Good Society* (Boston: Little, Brown & Co., 1937); Henry Simons, *Public Policy for a Free Society* (Chicago: University of Chicago Press, 1948); David Mc. Wright, *Democracy and Progress* (New York: Macmillan Co., 1948); Ludwig von Mises, F. A. Hayek, Frank Graham, and many others. Despite some marked differences in the views of these writers on matters of public policy, I think there would be general agreement among them on the basic concept of liberalism.

doctrine of the essential dignity of the individual is diametrically opposed. Not only are there historical illustrations of this extreme group philosophy, but it is only too painfully clear that these philosophies do not die easily. We are today seeing, in certain countries of the world, a revival of the extreme view. It was expressed by Mussolini in the slogan "Nothing outside of the state and nothing against the state" and by the injunction that was impressed upon his people to believe, obey, and fight. Nor does one have to turn to such extremists, for in many instances in England, and in some in the United States, the demands of "general welfare," "social good," and other modern terms with the same import are placed well above the liberties of individuals. Thus it is clear that an assertion of the central position of the individual about 175 years ago was far from the platitude that it is sometimes considered to be today.

Because of this emphasis upon the individual, the doctrine of liberalism is sometimes identified as "individualism." The term does, indeed, describe one important facet of this philosophy. It is an individual philosophy in the sense just indicated that the economic and spiritual well-being of individuals is accepted as the goal. According to it, the actual devices or social forces must, in the last analysis, be judged by their effects on individuals and upon their moral and intellectual stature.

Another aspect of individualism is the inherent conviction in each person that justice requires he should reap where he has sown; that his own welfare should in justice depend upon his own efforts, sacrifices, and foresight; and that all he has a *right* to demand of society is opportunity, and especially equal opportunity, to seek his welfare on those terms. It is true, and fortunately so, that we do not apply this standard in its extreme form to others, for it would be a harsh world if justice were not often tempered by generosity. But to recognize and to act upon this important fact does not require an abandonment of the inner conviction that the major responsibility for a person's own welfare rests with himself. Thus one aspect of individualism and of the liberal philosophy is self-reliance, which incidentally is believed to be the only sound basis of self-respect.

The term "individualism" has, however, acquired a bad odor

in some quarters because it has been given the meaning of selfishness. That connotation is erroneous if selfishness is taken in its usual sense, for the doctrine merely implies that individuals shall be allowed to seek ends which to them appear good. Those ends can be as generous as the level of the morals of the people will permit. It should be remembered that the greatest philanthropic enterprises, as supported both by the rich and by the masses of the people, have in this country been individualistic in the sense that individuals contributed to them or not, as they saw fit. This is the highest form of generosity. Indeed, one can go further to say that it is the only true form of generosity. A person cannot be truly moral unless he has the freedom to be immoral, and he cannot be truly generous unless he has the freedom to be narrowly selfish. The contributions which the people of this country have freely made over and over through the Red Cross and similar organizations (at times, to the wonderment of the people of other countries) stand as a reply to those critics who would picture individualism as being merely crass materialism and money grubbing.

The doctrine of individualism implies a belief (or faith) in the inherent decency of persons. How often all of us, as individuals, have looked in puzzlement at the clash of nations, the disputes of capital and labor, and all the other turmoil and grasping for self-interest in the world today. How often the common man says that, if he could sit down with an individual foreigner or with his boss and "talk it out," they could surely arrive at some solution of their differences. This instinctive feeling of common people contains much truth and expresses an aspect of individualism. But if the world becomes more and more organized and if more of its affairs are handled by groups, this naturally beneficent force has little chance to operate. The golden rule, one must remember, was offered as a guide for individuals: it is highly personal. Its hope of fulfillment rests upon the assumption that the responsibilities of individuals are not to be shifted to states, unions, employers' associations, political blocs, or other centers of authority.

The other philosophic basis of liberalism is a belief in the rationality of men. This belief implies, on the one side, that

men are individually the best judges of their own welfare and that they are quite competent to handle their own affairs. On the other side, it implies that through free and reasonable discussion men can determine and mold their political institutions: they are not mere chips on some predetermined "wave of the future." It was on this latter point, incidentally, that Karl Marx and the other "scientific" socialists stood in sharpest opposition to the nineteenth-century liberals. The latter believed that men could through reason settle their differences and create their social and economic forms, while the former believed that class conflict was universal and inevitable and that new social institutions followed old ones as irresistibly as the processes of biological evolution or the movement of a glacier. This belief in inevitability has had a revival in recent decades, favored no doubt by the evolutionary concepts introduced by Darwin in the biological field and extended by others into the field of social affairs and, in part, more recently, by the obvious trend toward collectivism.[2]

A moment's thought will show that from a denial or minimizing of the rationality of men flow two alternative conclusions. First, if men are essentially stubborn and unreasonable, one may conclude that reforms and redress of grievances can be and have been accomplished only by force. This conclusion leads to placing reliance for social change upon revolution and to explaining past changes as the fruits of revolution. The second possible conclusion is that the changes which the world has made were the inevitable products of social forces which no one or no group could control. It is interesting to observe that orthodox socialism tries to ride both these horses at once. In most of Marx's writings, the latter theme was emphasized. He says that capitalism grew out of and succeeded feudalism; it has done a good job; but it cannot last, for certain inherent forces will lead to its demise; and the succession of socialism must occur as surely as feudalism had to yield to capitalism. When writing in this vein, Marx does not berate capitalists, for they are helpless

[2] See George Terborgh, *An Appraisal of the Fatalistic View of Capitalism* (Chicago: Machinery and Allied Products Institute, 1944) and Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Bros., 1947).

to avoid the natural course of events. At other times, as for example in the *Communist Manifesto* (joint authorship with Engels), Marx's invective is bitter, and he calls for the workers of the world to arise and strike down their oppressors. Here is an obvious inconsistency which critics of the socialist doctrine have often urged. If the new world is bound to come anyway, what is all the shouting and shooting about?[3] But while there is an inconsistency, it is not so hard to understand when we recognize that both force and inevitability are negative reactions to the liberal's claim of the rationality of men. The inconsistency merely indicates that socialists cannot quite make up their minds between these consequences or that some (the revolutionary socialists) adopt one consequence and others (the scientific socialists) adopt the other.

At the moment of writing, many Americans are baffled because they cannot understand the Russians. But is that surprising if one people starts with the premise that men are essentially rational, i.e., reasonable, while the other denies that premise? The one will rely upon logic and open discussion. The other will rely upon either force or evolution. At the moment the leading representatives of communism in action are relying upon force, while many of the intellectual apologists for communist ideals in this country are pinning their hopes on evolution. It would appear then that the American professors and other intellectuals, who—with great show of scientific objectivity—lay stress upon inevitable trends to which we should adapt ourselves because we cannot control them, are more closely allied to the violent, direct-action communists than is sometimes assumed and than these intellectuals would like to admit. They agree, at least, in repudiating one of the basic premises of liberalism.

Is it not significant that the symbol of communism, which is the very antithesis of liberalism, is the clenched fist? How revealing that is. It is the universal symbol of force. It is the negation of reason. One cannot conceive of that gesture being used to accompany the invitation, "Come, let us reason to-

[3] Some socialist writers, e.g., Fourier, Proudham, and Saint Simone, avoided this dilemma by placing reliance upon the force of example rather than upon inevitability or force. Generally, however, these writers were scornfully dismissed by Marx as "non-scientific."

gether." But that invitation has, from Socrates to our time, expressed an essential aspect of the liberal philosophy.

On the side of practical policy, the philosophy of liberalism has shown itself in several ways. One of these was in the establishment of civil and political liberties, including freedom of speech, freedom of religion, freedom of the press, freedom of assembly, and protection against arbitrary arrest. If these civil liberties appear to the present-day reader to be obvious and self-evident, that is itself evidence that he has forgotten the long centuries in which these liberties did not exist and the fact that they came to us as the result of the daring thinking and struggles of our forefathers in the not-too-distant past; it is also evidence that he has forgotten in how many countries these freedoms which we take for granted are today denied. It is dangerous, indeed, for a people to take for granted the blessings which are not free goods and which do not exist in the nature of things. In fact, these liberties are highly artificial in the sense that they are a product of conscious thought and effort; and the price of their preservation, as our forefathers well expressed it, is eternal vigilance.

A second expression of the philosophy of liberalism is in the rights of minorities. This particular aspect of liberalism is very popular today, at least as it applies to racial and religious groups. But every individual is a minority in one way or another and thus the only firm basis for the rights of minorities of any kind or classification is in the philosophic view of the importance of the individual. In the philosophy of liberalism, the rights of minorities must stand as firmly against the will of a majority as they stand against the will of a dictator. The essential question is not who exercises the power but whether the rights of a minority, no matter how small, against a majority, no matter how great or how powerful, are to be recognized and respected. To some, this aspect of liberalism is the most significant one. For example, one philosopher says:

> The political doctrine which has represented the loftiest endeavour towards common life is liberal democracy. It carries to the extreme the determination to have consideration for

> one's neighbour. . . . . Liberalism is that principle of political rights, according to which the public authority, in spite of being all-powerful, limits itself and attempts, even at its own expense, to leave room in the State over which it rules for those to live who neither think nor feel as it does, that is to say as do the stronger, the majority. Liberalism—it is well to recall this to-day—is the supreme form of generosity; it is the right which the majority concedes to minorities and hence it is the noblest cry that has ever resounded in this planet. It announces the determination to share existence with the enemy; more than that, with an enemy which is weak. It was incredible that the human species should have arrived at so noble an attitude, so paradoxical, so refined, . . . . so anti-natural.[4]

The two basic elements of the liberal idea—emphasis upon the individual human being and the belief in the rationality of men—lead to the practical conclusion that authority can and should be minimized. This is true because the first concept implies the right of individuals to manage their own affairs for better or for worse and because the second implies that we can increasingly place greater reliance upon reason and less upon force. Thus, with the advance of liberal ideas, there was an increasing emphasis upon attaining improvements in human relations through general education, the raising of moral standards, and a quickening of conscience in men's dealings with men. At the same time, there were the efforts to restrict the authority of the state, the power of private groups, and, in general, the authority of man over man. Advances in these lines were, as noted before, among the most striking accomplishments of the eighteenth and nineteenth centuries—the Bill of Rights, abolition of serfdom and slavery, and restrictions on the use of governmental power.

But in the last half century, this trend in Western countries has been reversed. On the part of well-intentioned reformers and the most cynical seekers of individual and group interests alike, there is the same reliance upon force. The chief

---

[4] José Ortega y Gasset, *The Revolt of the Masses* (translation; New York: W. W. Norton & Co., 1932), p. 83.

center of force in the modern world is the state; and, quite generally, proposals for reform have increasingly taken the form of "there ought to be a law" or that some administrative organ of government should be endowed with discretionary power. With some people this reliance upon force frankly goes to the logical extreme of glorifying the omnipotent state; these people are the socialists and communists. With others, chief reliance is placed upon functional groups, such as labor unions, farmers' unions, or business cartels; but in any event, main reliance upon individual industry, foresight, thrift, or even the altruistic impulses of individuals has declined. The common denominator of this way of thought is that the well-being of individuals is to be entrusted to others who will be empowered to employ pressures (coercion) and, in a wide range of activities, to override the objections of individuals.

This is why it is so difficult for those who today call themselves liberals to distinguish themselves (which they often sincerely desire to do) from the communists. The fact is that, as to the basic issue of the relation of the individual and the group, they are on the same side. The thoroughgoing collectivists would concentrate control in the powerful state; the other economic planners and self-styled liberals of our country would favor a mixture of more comprehensive state control with more powerful occupational groups. With many popular reformers, with moderate socialists and with communists, there is in varying degrees an impatience with the individual who is not in harmony with the generally approved views of the welfare of the group. In a basic sense they are all authoritarian in their approach.

This does not mean that when union leaders, for example, and their spokesmen in politics deny sympathy for communism they are at all insincere. On the contrary, it is a commonly observed fact that the most bitter opposition is often engendered between those whose differences are not profound. The great religious wars were not fought between Christians and infidels but between groups of Christians, whose differences in views were, as we see them today, less marked than their points of agreement. It may even be true at the moment that the best defense

against communism is a strong trade union movement, and, on the other hand, it is quite clear that a communist state would not tolerate trade-unions as we know them. But the real antithesis is between those who like and trust power solutions and those who dislike and profoundly distrust them. It is between those who would build up aggregations of power in smaller or larger units and those who would disperse private power groups and limit the use of that residual power which by its very nature lies in the state.

The traditional liberal philosophy is that individuals cannot be trusted to exercise unchecked power over others. This distrust was especially strong, and properly so, when the directed had no voice in the selection of their directors nor any effective veto upon their orders, but it is not confined to such cases. As Woodrow Wilson once said, "The history of liberty has been the history of limitations on the power of the government." The proposition seems equally valid whether the government derives its support from a majority or a minority. The question much discussed in this country before World War II as to whether the Nazis really had the support of a majority was in this view not relevant. The essential fact was that the rights of minorities were not respected. The issue is whether and how far individuals are to be dominated by the group. How the representatives of that group are selected is no doubt an important practical question for good government and especially for determining the organic law by which a people decides on the general type of society under which it wishes to live; but, as to the basic, i.e., philosophic, question raised between liberalism and authoritarianism, it is of secondary importance. The important question is what rights do the 49 per cent have against the 51 per cent? or, indeed, what are the rights of one person against 135 million?[5]

There has been an important shift of emphasis on these points from the early days of our government to the present. The great liberals of that time were not primarily concerned with majority

[5] It is also obviously important that we have able men in our government. As Winston Churchill said when the Socialist party appointed Sir Stafford Cripps as director of economic affairs: "It is at least a comfort to know that we now have a first-rate intelligence brooding upon our affairs." But that, too, is, in the liberal view, a secondary question to the basic one of the scope and extent of authority.

rule—indeed, perhaps not as much as they should have been—for the suffrage was, of course, quite restricted. But they were vitally concerned with the rights of individuals against *any* government, and they expressed that concern in the principle that the government had only such powers as were expressly granted to it; and, then perhaps superfluously, but just to make doubly sure, they adopted the Bill of Rights. Today we are greatly concerned that everyone shall have a voice in selecting his governors, but we are not so much concerned about protecting the individual's rights against those governors. For example, many people feel that constitutional limitations in the use of power by government should be brushed aside if an act of the legislature is designed for a good purpose and, especially, if the legislation has popular support. Also, many people seem to feel that the vital question about private groups is whether the officers are honestly selected and responsive to the wishes of the majority. The question whether such representatives of a majority shall have the power to limit the freedom of individuals is pushed into the background. To the traditional liberal the latter is the essential question; and must we not admit that the relative areas of freedom of the individual, on the one side, and of the group's mastery over the individual, on the other, is a more profound question than that of who shall wield the authority for the group? On this question of the individual against the group, traditional liberalism and the modern brand parading under the same name are irreconcilably opposed. There may be, and no doubt there must be, compromises, but the ideals cannot be truly reconciled.

An implication of the exaltation of the individual is that he shall have the maximum of freedom of choice in all his activities. In the religious sphere, this means that he shall be free to choose his own religion; in the civil field that he shall be free to hold and express opinions of his own; and in the political field that he shall be free to exercise his vote to choose his own governors. But there is also the essential matter of freedom in the economic field which we cannot separate from the other freedoms.

In the first place, freedom in the economic field means that

consumers shall be free to buy or to save. They must be free to exercise such purchasing power as they have to buy what they please. This proposition rules out sumptuary laws and regulations, which were very common in the past and which attempted to direct the consumption of the people in such a way as to advance the welfare of the state or of the people themselves. This aspect of the doctrine of freedom is a difficult one for some generous-minded but paternalistic persons to accept. Sir William Beveridge, for example, is disturbed about the foolish purchases that people make; and he cannot resist the very natural desire to direct them into those lines which, in the judgment of some superior authority, would be more wise. The true liberal must forego, once and for all, the prerogative of playing God. The view that "Papa knows best" is difficult to renounce, but in the philosophy of liberalism it must be renounced; it must be remembered that freedom must include the right to make mistakes. The hope for raising the standards of taste and wisdom in expenditures and in consumption must rest upon the indirect approach of education and upon a faith in the fundamental rationality of individuals.

The freedom of people as consumers must also extend to a choice of where and from whom they shall buy. It is thus the basis of free trade, both within the country and between countries. Within the country consumers must be able to choose between alternative sellers, and this means that there must be alternative sellers. Sir William Beveridge, for all his protestations about the importance of "essential" freedoms, does not appear to recognize this point, for he asserts that the freedom to establish a business is not an essential one.[6] But if individuals can only buy from those limited sources to whom the state has given a license to engage as enterprisers and sellers or, still worse, if they can only buy from the state itself, surely their own freedom of choice has thereby been limited. This instance illustrates, as well as any, the difficulty of limiting freedom in some areas and of some important groups without limiting the freedom of all others. It suggests that freedom is an

[6] Sir William Beveridge, *Full Employment in a Free Society* (London: G. Allen and Unwin, Ltd., 1945), p. 23.

indivisible thing. One cannot adhere to it in certain respects one favors at the moment and deny it at other times.

In the second place, economic freedom must include the freedom of individuals as workers to determine for themselves how much they shall work, how hard they shall work, in what lines of activity they shall work, and in what parts of the country they shall work. The highest practical degree of freedom in this respect, as in all the others, will fall short of perfect freedom, for it is clear that some individuals will be precluded from engaging in certain occupations because of physical handicaps, intellectual limitations, and lack of training. This freedom is also limited at times by the general level of employment. It is, therefore, an ideal toward which we should strive rather than a possibility which, in its complete form, can be guaranteed.

But while these conditions cannot be guaranteed, the state at least can avoid on its own behalf the imposition of barriers to this freedom of choice. Further, it can and should use its influence to prevent private groups from imposing such barriers —for example, the limitations placed upon freedom of entry by certain labor unions and the limitations placed by many of the separate states upon the migration of professional workers. Still further, the state can enhance this freedom of choice by an effective employment service, by the dissemination of information about job opportunities, and by job training programs. Indeed, the whole field of education has the effect of enhancing this freedom of choice.

The freedom of workers, as part of the concept of economic freedom, encounters serious obstacles in any society which attempts extensive economic planning. For in such a society there must be certain objectives as to the kinds of goods and the relative quantities of goods to be produced. Under such a system the workers of the country must be regarded as "manpower." We all use this term at times as a form of verbal shorthand to mean the whole lot of individual workers, but it is sometimes used with an implication that is obnoxious to thoughtful liberals. For to them one cannot talk about human beings as though they were bricks or *things*. Even in the short period in which the ideals of the planned economy have pre-

vailed in England, there has been a disconcerting tendency on the part of the state to deal with workers as *things*. For example, under recent regulations any unemployed person must seek employment through the national employment service, and he must be willing to accept employment in those places and occupations to which he may be directed on pain of a denial of unemployment benefits if he refuses to conform. A justification can be made for such rules, but that justification is only plausible if one starts with the assumption that the general welfare, as defined by the state, is more important than the rights of the individual. That is indeed a valid justification in wartime, and some English observers regard the postwar reconstruction period as really an extension of the war. Others appear to regard the concept as the only appropriate one at any time.

Economic freedom should also extend to enterprisers. Individuals should ideally have the choice of being hired men or self-employed or of employing others. A society, to realize these ideals, must have a considerable flexibility and variety in its economic organization. Large business organizations must occupy part of the field in the interest of efficiency and cost reduction as well as to provide opportunities for the thousands of people who would prefer to be employed rather than to assume the risks and responsibilities of being employers. But a good society must also maintain a favorable environment for small business, for those who prefer the way of life which that type of enterprise provides both for employers and employees. And this environment should also be one that is favorable to small businesses becoming large businesses, for that is one of the natural ambitions of small enterprisers.

Finally, the ideal of freedom of choice will, under a liberal philosophy, be extended to other societies. Under it, no one national sovereignty, or even any prospective world sovereignty, should presume to limit the freedom of choice of another country as long as that country does not interfere with the freedom of others.

This suggests a general observation on all of these forms of economic freedom, namely, that the freedom of one unit must be limited when its exercise infringes seriously upon the similar

freedom of other units. It is admittedly difficult to draw this line. It is clear that the freedom of individuals to use narcotics can properly be restricted because of the harm that those individuals may do to others. It is likewise clear that in certain lines workers should not be permitted to practice an art or profession unless they are adequately prepared because again they may do positive harm to others. Enterprisers also may properly be restricted from producing and selling goods which are positively harmful. Lastly, even international pressures may be properly brought to bear upon certain practices of a foreign country that interfere with the freedom of others. But even under a broad interpretation of this principle, we are rarely justified in requiring individuals to act positively in such ways as the authority may believe would contribute most to the general welfare. For that welfare includes freedom as one of its most important elements, and to gain other ends at the expense of such freedom may well result in a diminution in real welfare.

## EQUALITY OF OPPORTUNITY

What we have said about extension of the area of freedom of choice implies a maximizing of opportunities. In a free society, opportunities for individuals to realize their greatest potentialities should be maintained with as little interference as possible. Now we need to add that, under the liberal concept of the good society, this opportunity should be, as nearly as possible, equal for all citizens. Equality of opportunity can best be understood by contrast to its opposite, which is privilege. We use the word "privilege" in its strict sense which is well suggested by its etymological origin, a combination of the terms *privus* and *lex*, that is, private law. Privilege thus derives from those special concessions and rights granted in the preliberal age by the sovereign to certain individuals or groups of individuals as a peculiar benefit to be enjoyed by them as against other individuals. It, therefore, implied a derogation or reduction of the rights of others. Today, in the strict meaning of the word, a privilege is a right or a prerogative which some individuals

enjoy and which others do not possess. It is thus the opposite of equal rights and equal opportunities.

In a liberal society these privileges should be reduced to the minimum. In the words of Abraham Lincoln, it is the duty of government toward men "to lift all artificial weights from their shoulders, to clear the paths of laudable pursuits for all; to afford all an unfettered start in the race of life."[7] That brief statement can stand as an expression of one of the important aspects of the philosophy of liberalism. To approach the ideal of equality of opportunity requires that the state should not grant special privileges. But its responsibility goes farther; it must strive to minimize privilege, whatever its source.

One of the most important privileges that people in many countries have in modern times, and perhaps have always had, is the privilege of education. Accordingly, it has been quite consistent with the liberal view, which aims at abolishing privilege, to extend the opportunities of education to ever wider groups of citizens and to ever rising levels. Historically, the other great source of privilege has been inheritance. Here, too, the placing of limits upon inherited wealth or position has been a practical manifestation of the liberal philosophy. Much more remains to be done along these two lines, and this need will be stressed subsequently when we discuss the elements of a positive program. The privileges created by unequal opportunities for education and by inheritance are mentioned here because the limitations placed upon them have already provided two of the important manifestations of the liberal idea.

## RESOLVING THE CLAIMS OF SOCIETY AND INDIVIDUALS

But all of this emphasis upon the rights and freedoms of individuals is not to deny that we do live in an interdependent society, and in that sense it is clear that both the society and the individual have their claims. There are certain ends which a successful society simply must attain. It must provide the goods and services which its members require in such abundance as its people may desire and its resources permit. It must provide

[7] From a special message to Congress, July 4, 1861.

some mechanism by which individuals will be induced to contribute to this abundance. It must direct productive efforts to producing those things which are most desired. In doing this, it must allocate the productive resources to some things and away from others. It should provide for increasing the productive factors in so far as their supply can be controlled. It must also provide some mechanism for allocating (rationing) goods that are inadequate to meet desires.

It will be observed that all of these economic requirements arise out of the fact that economic goods are "scarce" in the only true sense of that term, namely, that the desire for them exceeds the supply of them. Indeed, if that were not true, they would become "free" goods and hence not "economic" goods. Mankind is, always has been, and, as far as we can see in the future, always will be faced by scarcity in this sense. There has been much nonsense talked about poverty in the midst of abundance and that we have already solved the problem of production. The problem of producing the necessary goods for the support of the standard of living we desire, both for the world and for this country, is far from being solved. To *increase* the production of desired goods is still the number one economic problem of all societies.

This list of ends which a successful society must attain is indeed formidable; and one might be excused for concluding that, if all these things are to be done, the organized society must be supreme and that the individual must submit wholly to its demands. But that statement is a denial of the chief social end, which is to enable individuals to advance their own intellectual, spiritual, and economic ends. To approach this ideal, individuals must be free to be good or bad, wise or foolish, to produce more or less as they see fit, to work or loaf, and to work at those particular things which they may choose. There can never be a perfect reconciliation of two such conflicting basic demands. The modern democratic-capitalistic solution is to make it attractive through prices (wages, profits, interests, and rents), prestige, and social approval for people to do those things which the society wants done and, at the same time, to allow the individuals freedom to do otherwise if they so choose.

This is an incentives system. If, for example, the society needs more engineers, the rewards of an engineering career, both in monetary and prestige terms, will be increased on the simple principle that value attaches to those things which are desired and scarce. In response to these incentives, more young men will be expected to choose this field; and when there are too many of them, opposite forces will direct individuals into other lines. Under this system it is unnecessary for anyone to issue arbitrary orders for people to go into this field or to impose prohibitions against their going into that field. The incentives system does not work perfectly, and we recognize this during wartime when we rely on other forces to man the defenses of the country; but in peacetime, when desired ends are varied and when we can permit these individual ends to direct our activities, it serves better than any other method to reconcile the conflicting demands of the group and the individual. Because it is not a perfect solution, there are always those who would go farther in the one direction or in the other.

As a practical matter, the contrast between a liberal program and an authoritarian or collectivist program is likely to be a matter of degree. But to say that it is only a difference of degree does not mean that the difference is unimportant. There has been much foolish talk, both by advocates of traditional liberalism and by those who lean to authoritarian solutions, in which the members of both camps have tried to define the other's position in such a way as to make it untenable to any reasonable person. Such tactics may serve the purpose of exposition by sharpening the contrasts, but, on the whole, they probably do more harm than good.

Let us try to define the issue in such a way as to avoid forcing the answer. Traditional liberalism as a practical policy implies that, in the solution of economic and social problems, the maximum of reliance will be placed upon the energies and initiative of individuals following the course of action which to them seems best; only to the necessary minimum does it rely upon the force of the state or the concerted action of interested groups within the society. Or we can say that traditional liberalism relies to the greatest practical extent upon the spontaneous

and natural forces of a free market and a free society; and only when these forces are clearly inadequate, does it resort to compulsion. These statements are intended to imply that a liberal policy is not a strait jacket, nor does it preclude the use of authoritarian methods when they are necessary, as at times they surely will be. But the liberal statesmen will place the burden of proof upon those who would resort to such methods; whereas it is submitted that statesmen of the opposite school of thought appear, when faced by any problem, to think first of action to be taken by the state or labor unions, by farm blocs or similar centers of private power, and only when those favored devices are shown to be too clumsy and impractical, will they fall back upon the solution of letting people work out their own salvation.

The authoritarian is partial to the use of direct action, i.e., to force (for good ends, of course). The liberal favors indirect action, i.e., persuasion and education, the slower process of raising intellectual and moral standards. He believes that mankind can raise itself to a level where individuals can seek their own ends and, at the same time, respect their neighbors' right to do the same. Despite practical difficulties in drawing the line, these two philosophies are opposed, and the opposition is not temporary. The clash of ideals has, in one way or another, recurred throughout the history of civilization and will not be finally settled in this generation or the next.

## ACCOMPLISHMENTS OF LIBERALISM

It has become fashionable in many quarters to disparage the past in favor of the "brave new world." Particularly the nineteenth century has been thus treated. It has been scornfully called the "horse-and-buggy age" and an age of "crass materialism." But this is a superficial view. During the nineteenth century, the ideology of liberalism prevailed in the countries which were, in fact, the leaders and whose policies were profoundly influencing the whole world. During that period, the world enjoyed a material prosperity which, in its absolute level, had never been attained before and which exceeded all earlier periods in its rate of progress. It would be difficult to give any

reliable figures that would measure this productivity for the whole world, but the effect of it was reflected in increased population. During that period it is estimated that the population of the world doubled; the population of western continental Europe trebled; the population of Great Britain quadrupled; and the population in the United States increased some twentyfold.

Moreover, it is a matter of common observation that this larger number of people enjoyed a higher standard of living. That improvement was very marked in the industrialized countries; but through the influence of trade and, hence, the possibility of each country's specializing in its most effective lines, the improvement in living standards extended to the whole world. This improvement was to be measured not merely in terms of a better supply of such basic items as food but also in the manufacture of many utterly new products and the improvement in the quality of other products. In short, on the material side, many more people were supported at higher standards of living. Nor should this improvement be discounted as merely material, for the raising of standards above bare subsistence made possible improvements in other aspects of life which may be considered much more important. For several countries as a whole and for large masses of people in other countries, the fear of famine and starvation was abolished. In view of the fact that these two had always been among the major scourges of mankind, this was no mean accomplishment.

Beginning with the late eighteenth century and extending through the nineteenth century, there was also a great extension of freedom in several of its aspects. There was the growth of political democracy in the older countries; the establishment of the United States as a free country; and the development in it of democratic institutions. The century saw the final abolition of slavery and the disappearance of serfdom in the Western world. There was also the abolition of many restrictions upon the free movement of workers from one occupation to another and from place to place within the world. The large migration to the United States was an example.

Public education came into being during this period and

brought with it a revolutionary change in the degree of literacy. The higher institutions of learning also prospered, both with private and public support. While there is little evidence that the best educated people of 1900 were markedly superior in wisdom and broad culture to those of 1800, it is clearly true that many more people were educated both at the elementary and higher levels.

In international relations it was a period of increasingly free contacts. On the material side, the policy of free trade developed and indeed extended so far that by the middle of the century it was possible for Cobden, the great free trade statesman of England, to say that he considered the extension of freedom of trade to the whole world to be as sure as the rising of tomorrow's sun. This extension of free trade, which was generally accepted as an ideal even by those who defended protectionism for various temporary reasons, was a reflection of the growing attitude of educated people that they were citizens of the world. This genuine internationalism was apparent in many ways. The Russian composer, Tschaikovsky, and the Polish composer, Chopin, were as much at home in Paris as in their own countries. The culture of the world, which to a considerable extent was European culture, was not nationalistic. There was, in short, a free trade in ideas and ideologies which matched the free trade in goods. It is significant that these extensions of cultural contacts came naturally as an expression of the spirit of the times.

We are today striving to create such contacts in artifical ways with associations and foundations and with a special assistant secretary of the Department of State in charge of cultural relations. These activities, although they can be commended in view of the conditions that face us, are a poor substitute for a spontaneous and natural sharing of cultures. The expression "one world" was coined by Wendell Willkie, tragically enough after the fact of one world had ceased to exist. We were closer to attainment of that ideal in the nineteenth century than we have been since that time.

The policies of statesmen and diplomats, although serving the interests of their nations, were largely directed to the main-

tenance of peace. If this be doubted, it should be borne in mind that the ideal of international peace was largely a development of the eighteenth and nineteenth centuries, corresponding almost precisely with the development of liberal ideals. Prior to that time it was considered, even by such men as Grotius, that war—or at least an attitude of war—was the normal relationship of nations. Moreover, in the actual record, if we can consider for a moment the nineteenth century as extending from the end of the Napoleonic Wars in 1815 to the outbreak of World War I in 1914, this was the most peaceful period that Western civilization has known since the fifteenth century. This conclusion is based upon quantitative studies which measure the extent of wars by the number of them, the number of participants, the number of casualties, the number of countries involved and the proportion of combatants to the total population.[8] By comparison the seventeenth and eighteenth centuries preceding, and, even more, the twentieth century following, make a very poor showing. Not only were actual conflicts at a low level during the nineteenth century, but statesmen, poets (Tennyson, for example), and others had come by the end of that one-hundred-year period to regard war between great states as an anachronism. This view was expressed by Norman Angell in *The Great Illusion*, the thesis of which was that man in his spiritual attitudes and material interests had finally outgrown international conflict. Sadly enough, this conclusion, expressed in 1913, was followed within only a year by World War I and by the beginning of a new era of tribulation and conflict.

As with the attitude toward war, so in other fields the most promising feature of this period was the growing optimism which regarded the injustices and flaws of the actual world as but temporary imperfections which surely reasonable men in succeeding generations would remove. The pessimism as to the future of Western civilization—indeed, the future of *any* real

---

[8] Index numbers based on these factors, taking the fifteenth century as the base period, show: fifteenth century, 100; sixteenth century, 180; seventeenth century, 500; eighteenth century, 370; nineteenth century, 120; twentieth century, 3,080. Harold D. Lasswell, *World Politics Faces Economics* (New York: McGraw-Hill Book Co., 1945), p. 7. Cf. also Quincy Wright, *A Study of War* (Chicago: University of Chicago Press, 1942) Vol. I, chap. ix.

civilization—and the recurring contemplation of the "next war" are developments of the twentieth century.

## DECLINE OF LIBERALISM

But toward the end of the nineteenth century and in the early twentieth century, there appeared a significant change in social philosophy. Some would call it an improvement upon traditional liberalism. Whether an improvement or not, it was a departure from the fundamental tenets of that philosophy. The manifestations, on the practical side, were the increased power of the state and, on the ideological side, the increased reliance upon group action to attain reforms and to bring the abundant life. This increased reliance upon group action and upon the power which such groups could exert led some people to favor schemes of state socialism and others to favor communism and the dictatorship of the proletariat. Most people of Western civilization did not go to these extremes; but they did accept the idea of the welfare state, that is, that it is the function of the state to provide for the welfare of its citizens and not merely to provide an environment in which they can seek their own welfare.

To these people it appeared that one of the most obvious ways in which the state could directly advance the welfare of its citizens was to grant privileges to groups. This movement can be called "groupism," as distinguished from "statism." Under this philosophy privileges were granted to manufacturers in the form of protective tariffs, and then such protection was extended to other groups in the society. Such special aids by the government to some groups naturally created a desire on the part of others for similar privileges, and these privileges, without too much resistance, were granted. The correction of inequities that would have been suggested by traditional liberalism would have been to eliminate the special privileges possessed by some and, thus, to establish or reinstate equality; but it was politically easier and more consistent with the basic thinking of the times to grant additional privileges to the other groups. Thus we have approached the self-contradictory policy of special privileges for all.

Another symptom of a decline in liberal attitudes in the classic sense is in the popularity and some of the implications of the term "economic planning." This term came into popularity during the thirties, although the roots of the idea go far back of that time. There were indications of the growth of this idea in intellectual circles in the last two decades of the nineteenth century in this country, and there was a substantial growth of it in Europe, particularly in Germany, even before that time. In that country great social welfare schemes were promoted by the Prussian bureaucracy. A considerable group of young American economists who went to Germany for study were greatly attracted by this program and the philosophy that underlay it. These young men, as they returned to academic positions in this country, greatly influenced economic thinking, at least in academic circles. But up to the early thirties the practical influence upon statesmen, it seems fair to say, was largely confined to reforms in this field or that, most of which were not inconsistent with a reasonable interpretation of the liberal philosophy. Among these reforms were limitations on child labor, workmen's compensation acts, public regulation of natural monopolies, and others which were sponsored by Theodore Roosevelt and the Progressive party and by Woodrow Wilson under his banner of the "New Freedom." Indeed, even the "New Deal," as the term was used by Franklin Roosevelt in his first campaign for the presidency, covered a variety of reforms which most progressive thinkers endorsed. It did not imply a unified program, and the term "economic planning" was not applied to it. As the depression continued, however, the idea arose that a comprehensive plan of action to cope with it was necessary.

Another root of this idea is no doubt in the comprehensive planning on the part of large American business firms. In their case, great and comprehensive plans were laid, organizations were set up to carry them through, and all this activity excited the admiration of the world. It seemed but natural, therefore, that if American businessmen could in this effective way conceive huge projects and carry them through with efficiency and dispatch, that same American genius should be able to solve our great economic problems. On more than one occasion in our his-

tory, when we were faced by a critical situation, there has come this demand for the leadership of businessmen and the use of business methods and organization. To meet the crisis of depression it was proposed by business leaders, prominent among them Gerard Swope of the General Electric Company, that leaders of business, labor, and agriculture should combine their efforts to solve the great problem. Enlisted in support of this ideal was also a very different group of people, those who favored reforms of an equalitarian nature. From these varied sources, then —Prussian bureaucracy and state socialism in Europe, the indigenous reform movement in this country, the large scale planning and execution of plans by American business, and the aspirations of equalitarian reformers—there arose the concept of economic planning.

This concept differs from earlier reform movements in several ways. One is that certain broad objectives, particularly those having to do with the distribution of wealth and the maintenance of full employment, should be accepted as goals and responsibilities of the government and that deliberate and extensive plans should be drawn for realizing them. Broadly speaking, the earlier reformers had relied upon changing certain institutions and rules of law as, for example, in the case of the workmen's compensation acts—in other words, modifying at one point or another the rules of the game. The ideal of economic planning, on the other hand, involved the increase of administrative power and a more direct approach to desired ends. The analogy of a country at war was often used to express this ideal, for in wartime our national objective is clearly defined, and a concerted and organized program is set up for realizing it. Why not, it was asked, use such a program to solve peacetime problems? This approach appealed to many people who were attracted by socialist ideals of an orderly society but who were not willing to go all the way with the socialists along that line.

It is probably clear why we say that all this was a departure from the classic pattern of liberalism. Liberalism relies upon the indirect approach. It holds that the state should determine the basic rules but that the activating forces should be with individuals seeking ends that appear to them to be good. Economic

planning, on the other side, implies that there are objectives which the community, or at least the politically decisive groups in the community, accept and that these objectives should be sought by direct means. It is this implication of economic planning that warrants mention here as evidence of the decline of liberalism. There are obviously other implications which present no conflict. No one, for example, would doubt that, if an individual, business, or government is to carry out a program, he or it must plan that program deliberately. Indeed, anyone who objects to this philosophy applied to government is likely to be challenged with the question of whether he believes in unplanned activity. Obviously he does not. But he may still question whether the government should assume such responsibility in peacetime as will require it to direct the affairs of its people. Even though a person does not question the objectives, he may vigorously object to the direct means of reaching them.

Another concept closely related to economic planning—indeed, implicit in it—is the ideal of the welfare state. The essence of this idea is that the state is responsible for the welfare of its people, whereas under the liberal philosophy the function of the state is primarily to determine the rules and to influence the environment within which individual members may seek their welfare. The Declaration of Independence referred to life, liberty, and the *pursuit* of happiness. At one time it was regarded as humorous that some careless draftsman, in drawing up the constitution for one of the states, omitted the words "pursuit of" from the famous phrase, so that the unalienable rights guaranteed by the constitution included happiness itself and not merely the pursuit of it. But under the modern concept of the state in relation to its citizens, that broad statement would apparently be accepted in all seriousness by some people. Of course, there are a number of implications in this view. If the state is responsible for the welfare of the people, it must decide what that welfare consists of. Furthermore, it must *act* to assure that welfare. This calls for the use of force in one form or another. Dissenting minorities must be overridden for the sake of the general welfare. Government, i.e., parties, must be allowed some continuity of control to carry out these

programs. So the logic of that view extends to degrees of control and kinds of government of which the sponsors perhaps never dreamed.

Many well-intentioned reformers will deny any relationship between the strengthening of occupation groups, the concept of the welfare state, and a program of economic planning, on the one side, and the program of the socialists and communists, on the other. Basically, however, they all have much in common: they all rely upon the actions and powers of groups, some of them upon groups within the state and others upon the state itself; they all hold the individual and his freedom and aspirations to be less significant than the social good, general welfare, or interests of the state. There are differences, it is true, just as there are differences between communism and fascism. But in this view the common characteristics of economic planning, groupism, state socialism, communism, and fascism are more important than their differences. They are all opposed to individualism and traditional liberalism.

Whatever one may think of these different ideologies, the fact is apparent that the world presents a very different picture today from that which was envisaged by the philosophers and leaders of traditional liberalism. On the political side, a large part of the world is totalitarian. Other countries, in which it was supposed that democracy was well established, are now wavering between that system and some form of socialism. England, the traditional home of liberalism and free trade, has gone first to protectionism, then to a high degree of groupism (labor unionism), then to economic planning, and finally to avowed state socialism. The United States is the last great industrial country holding to traditional democratic-capitalistic forms. And in this country the role of the state has tremendously increased until something like one-third of the national income is spent by various governmental units; and to a degree undreamed of in the past, occupational groups have attained power, for better or for worse, to control their individual members and to impose their will upon other members of the society.

# 22

## *THE CRISIS OF LIBERALISM*

WHY did a policy and a philosophy that seemed so well established and gave so much promise decline in such a short time? It is as impossible to give a complete explanation for this change as it is to give a completely satisfactory explanation of the rise of liberalism in the first place. But a number of points may be noted.

### REASONS FOR THE DECLINE OF LIBERALISM

In the early days of our country a potent check to the extension of government powers and to any infringement through organized group action upon the rights of individuals existed in the memories of the struggle for the freedoms recently gained. Now, the very success of the liberal policies of the late eighteenth and nineteenth centuries have established our civil rights and economic freedom so well that many people have come to accept them as a matter of course and thus to regard them in the same class as sunshine, fresh air, and other free goods. But people are not solicitous and careful about their free goods, and the preservation of them does not determine people's actions. So it is with social blessings which are taken for granted. This does not necessarily mean that people in the Western countries place a low value upon their liberties. That they do value them is shown when a crisis arises—for example, the people of this country arose in fine spirit during the two world wars when they believed that their liberties and way of life were threatened. Rather, the effect has been to lull us into a feeling that, except for such obvious threats as those of a foreign enemy, a subversive antidemocratic group within our borders, or a would-be dictator, all will be well. The more insidious erosion of property rights and the rights of individual workers and others caused by well-meant reforms does not today

cause the alarm to us that they would have caused to our forefathers. This change in mass psychology is favorable to the extension of group powers.

In some countries there has also been a tendency to identify the interests of all the people with the will of the majority. There are indeed times and situations which require concerted action for the very preservation of the state, and in those circumstances the welfare of the national group must override that of any individuals within it. However, it should be remembered that the philosophy of liberalism holds that individuals have rights against the majority. This is a special instance of the weak enjoying rights which the strong are obviously in a position to take from them. The imposition of the will of the majority upon the minority, that is, the weak, is encouraged and justified when the former persuade themselves that their welfare is the welfare of the whole. The decline in the regard for individuals and their rights which this tendency represents is perhaps not surprising. Indeed, as we have said before, the surprising thing is that such a relationship of the strong to the weak should ever have existed.

It may well be that such a high ideal as liberalism required the support of a formal religion which emphasized the importance and dignity of individual men. The force of formal religion is probably less today than it was a century ago. Indeed, the ideals of liberalism have fostered and encouraged rational inquiry and the scientific attitude which, in spite of its many values, has helped to undermine this formal religion. The result has been that in place of the will of God we are glorifying the will of the majority. And the place of Providence in men's minds is being usurped by the providential state. These trends have gone far in some other countries. But evidences of this trend in ideology even more than in practice are not entirely absent in our own country.

Then there has developed a yearning for security. In the preceding centuries men were born to or assigned to classes in society, and their rights and welfare were largely determined by this status. A feature of liberalism has been to break down the security which such arrangements implied. The rate of

change technologically and in other respects in the last one hundred and fifty years has been terrific. One writer has called it a perpetual gale. Just as a child may, after a brief freedom, want to return to the greater security of his parental home, so Western people have a yearning for security, even if it means less freedom. While some thinkers frankly assert that freedom or security is the choice, more people believe we can enhance both freedom and security. In one sense of the term "security," that is possible. For if in a free society the level of production is high and the economy is expanding, opportunities will be great, and those conditions in themselves will provide genuine security.

But to many people, security means more than an improved chance to strive. To them it means the assurance of good things regardless of effort and the prudent direction of that effort. Security for all, in that sense, is an illusion, for it is clear that if the total environment is changing, as it must change if we are to have progress, then the guarantee of security to anyone or to any one group must increase uncertainty for the others. If, for example, the rate and character of change means that there is a real possibility that the national income may drop by 25 per cent and if certain groups have been able so to entrench themselves through rigid wages or prices that their own incomes would only suffer by 10 per cent, the result will be that others must take a reduced income of *more* than 25 per cent. The stability of one group in an unstable society can, generally, be attained only at the expense of exaggerated insecurity to others.

Another reason for the decline of the liberal-individualistic philosophy has been the increasing interdependence and complexity of modern economic society. These features of our economy have been accompanied by the view that the greater the complexity of a social system, the greater is the need for central control of it. If "control" is used in the sense of defining and enforcing the rules of the game, there is truth in this view; but if the term is used, as it is used in connection with economic planning, to mean the substitution of the decisions of government for those of individuals in their economic affairs, it is fal-

lacious. The greater interdependence of people today is a reflection of an increased division of labor. Increased division of labor requires an extension of markets and an increase rather than a decrease of the freedom of individuals to adjust themselves to the requirements of the market. Such an interdependent and specialised system must, if it is to be successful, have an increasing rather than a diminishing degree of flexibility. In this view, therefore, our aim should be to reduce monopolistic elements and every other source of interference with the free flow of productive factors and goods. Moreover, aside from the need, the feasibility of centralized and conscious control declines as a society becomes more complicated. It would be comparatively easy to regulate the use of resources in a simple agricultural economy. There is evidence of this in the fact that successful autocracies in which human freedom was at a low level have been found only in such simple economies. A system of slavery was not impossible under the simple plantation economy of the South; but as a practical matter it was out of the question for the more dynamic, commercial and industrial civilization of our North and East. Nevertheless, this illusion has been very influential and has served as an intellectual support for policies which often were really inspired by other considerations.

Closely related and supporting this erroneous line of reasoning has been the growth of scientific knowledge. The advancement of science implies that knowledge can be reduced to scientific principles and generalizations. Knowledge of this kind is the special possession of the scientist and the expert. If that is true, then it would seem to follow that a society will be well directed if these wise men are permitted to impose their superior knowledge upon the less able and the less well-informed members of the society. Thus, there has come a modern revival of Plato's conception of the good society—it was to be ruled by kings, and the philosophers (i.e., the wise men) were to be the kings. But all this rests upon a great exaggeration of the extent to which the knowledge by which men live can be concentrated and centralized. The more complex and subdivided a society bebecomes, the more important becomes the area of knowledge

which is possessed by the ordinary citizen, and the greater becomes the need for his freedom to exercise that individualized knowledge of special times, places, and circumstances.[1]

For example, a young man undertakes the task of manufacturing a new gadget. Despite some general principles which may be imparted to him by experts, by far the largest part of his problem must be solved by him individually in view of the particular circumstances which obtain at that time and place, and which are perhaps not precisely reproduced at any other place in the world. He must decide whether people will desire his product, how much of it they will desire, what his costs will be, and how he can best keep those costs at a minimum. A modern society must be directed primarily by this great mass of knowledge which is possessed by the millions of individuals, each striving to so adapt himself and his actions as to serve the community and thereby to advance his own interests. (Incidentally, it is only individuals themselves who in the philosophy of liberalism have a right to determine which of their interests they will seek.) The integration, therefore, of the contributions of science with the ordinary knowledge which each individual possesses about his own affairs is not to be attained by any such simple solution as to endow the experts with greater powers.

Another explanation for the tendency to conscious and centralized control is a very real one. It is the fact that a number of industries are of such a nature as to make the operation of competition impractical. These we have come to recognize as public utilities; and since for them the normal regulative forces of competition do not suffice, they must be regulated as to rates and quality of service and equality of treatment of consumers. Toward the end of the nineteenth century and increasingly since that time, these controls have been extended as was natural and proper. But the very success in controlling this segment of our economy has induced in many people an exaggerated view of the need and possibility for the same type of control in other fields. Rather than a recognition that these other fields are dif-

[1] Cf. F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review*, September, 1945, pp. 519–30.

ferent, there is a growing tendency to apply the concept of public utilities to industries and occupations which are not in the natural monopoly category. This exaggerated tendency reflects a failure to recognize the natural function of competition and the distinction between those areas in which it cannot be trusted to function and those others in which it is the best regulator and in which the remedy for monopoly should be to destroy it or limit it.

Outside the field of public utilities and others where natural monopolies exist, there has been a change in the nature of competition. To this change people have reacted differently. There is one group which, while recognizing that there has been some changes in the nature and forms of competition, believes that it is still the best regulator of the economy and that we only need to prohibit its violations and extend its influence. But there is another group which feels that this decline has gone too far to be checked and that it is indeed inevitable. This group would accept that fact, substitute for competition more extensive regulation of the economy, and thus would move away from the whole liberal system. In some countries this last group has very great force, and, indeed, in this country at times it has enjoyed powerful sponsorship. This point of view is closely allied to that of the socialist who denies not only the practical possibility but also the theoretical desirability of competition and believes that conscious co-operation, that is to say, control by the group, should be substituted for it.

In contrast to these shifts in ideology, there have been certain very practical forces which have led to the extension of the power of the state. The most important of these forces have been the two great world wars, in which this country and most of Western civilization have been involved in the twentieth century. In many respects the most potent enemy of the liberal way of life is war. For war leaves little room for the individual aspirations of men and demands that the actions of all shall be bent to a single national purpose.

Only slightly less potent are the pressures created by a great depression. During such a period the problems that affect everyone are or seem to be created by great social and economic forces

with which the individual is powerless to cope. Like a war, therefore, a depression encourages the extension of governmental powers, and perhaps still worse, it leads to the establishment and strengthening of private power groups. This is even more dangerous to the liberal way of life than the increased powers of the government occasioned by wars because it is more difficult to eliminate or to reduce these private powers once the emergency is past.

As we remarked in our first explanation of the decline of liberalism, people tend to become careless of blessings which they have merely inherited. This complacency induced in the minds of many people the view that the struggle for freedom had been won. This view was expressed by poets and philosophers in the latter part of the nineteenth century in the conclusion that the progress of all the ages had culminated in this best of all possible worlds. Such a philosophy naturally provided a support for those individuals and classes who still enjoyed privileges and for their very natural attitude of extreme conservatism and standpattism. But this was, of course, a distortion of the philosophy of liberalism for selfish ends. The needs for reform were real. Instead of relying upon the only partially realized ideals of liberalism, the humanitarians and especially the young reformers turned to an opposite philosophy. We are thus, in the words of Walter Lippmann, "a generation that has lost its way." There has fortunately been no diminution in the desire for reform; but partly because of the opposition of many of those who falsely carried the banner of liberalism, the reform spirit struck off in new and strange lines. In this view the vehicle of mankind was proceeding during the nineteenth century along the right road. For a number of reasons it became stalled. The real problem was for young reformers to get it started again on that road. Instead, many of them took a bypass, a short cut, which, in the opinions of some, leads back to the bottom of that long hill which the human race must climb if its potentialities are to be realized.

The view that progress lies along a road, which was indicated by social philosophers and statesmen of the past one and a half centuries, is expressed in the term "conservative-liberal."

If this hyphenation appears to be a contradiction in terms or a milk-and-water halfway position, it is because in popular usage "liberal" has come to mean "new," and "conservative" a defense of "status quo." But that is a superficial interpretation of the terms. The liberal philosophy is the timeless and definite body of concepts which we have tried to explain. It has a set of ideals which are far from realized. One who is attached to these ideals will try to preserve them, i.e., *conserve* them, and in so doing he is at the same time, in a correct sense of the words, conservative and liberal.

Whether one is or is not a progressive depends, not upon whether the ideals which he pursues were first enunciated this morning or one hundred and fifty or two thousand years ago, but rather on whether those ideals and their practical implications are dynamic and forward looking or whether their nature and their probable consequences favor rigidity and a static state of affairs. It is our view that a philosophy which points to a freeing of the restless and creative energies of individuals is in its nature dynamic and, if generally pursued, would be most fruitful in yielding progress. Liberalism is, or should be, the perennially youthful approach to human problems.[2]

## A POSITIVE PROGRAM OF LIBERALISM

If, then, the problem is to get the people of this and other Western countries again started on a highroad which was correctly envisaged by the great liberals of the past, it is clear that their present-day followers must have a positive program. To an unfortunate extent, people who hold to a doctrine of individualism have allowed themselves to be backed into a purely negative position. That is understandable. If I am a householder and a hostile mob is proposing to burn my house, it is natural that I should concentrate my attention upon preventing that disaster. If that danger could be removed, I would be able to

[2] A friend whom I regard as a true liberal remarked, "I am a conservative in the sense that I want to conserve the rights of radicals to be radical." When the terms can be used quite properly in these different ways, it appears that the real distinction is not between "liberal" and "conservative" but rather between "liberal" and "authoritarian" or "liberal" and "collectivist" or between "liberal" and "socialist," if we use the latter term in its broad sense.

turn my attention to improving the house—putting on a new porch and expanding the old edifice. But, understandable as the position of liberals may be, they must resist those temptations and must recognize that the best defense is offense.

What, then, are the features of a positive program of liberalism? To such a broad question one obviously cannot give a detailed answer, nor even in general terms should he be dogmatic. But despite these limitations, we can at least suggest some of the major elements of a liberal policy.

First, a positive program of liberalism should include eternal vigilance to preserve human and civil rights. When, by our muddling and erroneous policy, we come to a crisis, such as a tie-up of the railroads of the country, it is altogether too easy in a moment of exasperation to propose that train crews should be drafted into the Army and forced to operate the roads at the point of a bayonet if necessary. We must recognize that there are more important things in this world than making the trains run on time. Let us recall that that "accomplishment" was precisely Mussolini's claim to fame and that this and similar accomplishments led many thoughtless Americans to condone his impairment of human liberties.

Second, there should be a policy to disperse power wherever it is held by private individuals or groups. The power of coercion should be the monopoly of the state, but in a liberal and democratic society that power should be used cautiously, carefully, and economically. The most serious indictment to be brought against the modern brand of liberalism in this country, and specifically against some aspects of the New Deal, is not that it increased the basic power of the state. In a sense the fair criticism is just the opposite, namely, that it increased the power of private groups and transferred the power of coercion, which should be the final and overpowering weapon of the state itself, to private organized groups. Through the encouragement and exemption from prosecution of those private groups, this policy violated the principle that any state must observe if the rights of individuals are to be preserved. The doctrine of liberalism does not imply a weakening of the state or an impairment of the majesty of law. It does hold that law will retain

its majesty, first, as long as it is based upon principles that are universally applied and, second, as long as the sovereignty of the state shall be used sparingly. The actual use of power should be slight; the reserve of power in the state should be great and unquestioned.

The concentration of power in business monopolies, trade associations, farm blocs, or labor unions to such an extent that any of them can challenge the authority of the state itself is hostile not only to a democracy but to any form of organized society. Such interest groups will exist in any kind of a society; they may vie with one another for economic and other advantages; but the state representing the sovereign power must in the end be master of the house or we have anarchy. One of these groups, it is true, may seize the machinery and power of the state by peaceful or other means. But then it becomes the sovereign, and there is imposed upon it the same necessity of maintaining supremacy.

The constant effort, therefore, of government should be to break up these concentrations into smaller and less powerful units. The remedy for power, except when that power is in the hands of the state itself, is to disperse it, not to enhance it. The disgraceful impasses to which this country has come in the threatened strikes of railroad workers and coal miners were created by some very nonliberal policies which conferred upon private groups the power to hold up the rest of the community; and it is not surprising that the result of such policies was an equally nonliberal use of force, that is, the actual use in an extreme form of that reserve of power which must reside in the state. If the state still persists in enhancing the powers of special groups, the resulting necessary use of power by itself will necessarily be in a form which is least consistent with the preservation of individual liberties. For a government which asserts its ultimate sovereignty in reaction to the intolerable assertion of power by minority groups is likely itself to employ its power arbitrarily.

A third major objective closely related to this one should be the preservation of competition. It is clear enough that a condition of competition does not maintain itself automatically. Al-

together too frequently competitors do not like competition. The preservation of competition is one of those concepts which most thoughtful businessmen and workers recognize and admire in the abstract; but in the concrete and specific instances, they are always ready to limit it. That is the very reason why the state should act to preserve a condition of competition. For it can be stated as a general principle of government that the function of the state is to enforce those principles upon which we generally agree but which some individuals are willing to violate. For if there is not general agreement on the principle, the rule will not be enforceable; if there is not the tendency to violate it, there is no need of enforcement.

It is not, therefore, an exaggeration to say that in a democracy the major economic function of government should be to preserve competition among the members of the society, for it is the system of checks and balances in our economic system that directs activities of individuals into lines acceptable to society, without the use of force. The real and natural protection of buyers is in the competition of sellers, and the protection of sellers is in the competition of buyers; the proposition is equally true for goods and for services. The mutual protection of individuals through competition provides a better broad principle for meeting the requirements of individuals and society than any other which the world has yet employed or which is yet in sight. If and to the extent that the production of society's needed goods and services cannot be met by this method, we shall be forced into a system which will attain that end by force of one kind or another. As Professor Henry Simons well said, "A nation that is not willing to submit to the discipline of competition will ultimately find itself under the discipline of authority."

This function of government has been recognized in certain fields in the form of our antitrust laws. But government in recent years has been following a strangely contradictory policy as to other groups—such as independent retailers, farmers, and workers—so that it frequently appears not as the guardian of competition but as the sponsor of monopoly. If the policy is good, it should be followed consistently and applied to all.

Fourth, there are certain problems that the adherents of traditional liberalism have been too willing to leave simply to natural forces. Among these is the problem of individual security. This problem, viewed in its broadest aspects, is the most difficult one to reconcile with the ideals of a free society. The reason is that one ideal of freedom is that each individual shall have the opportunity to advance his interests, as he may define those interests and in the way that seems best to him, as long as he does not thereby infringe upon the liberties of others to do the same thing. But the freedom to seek one's self-defined interests in one's own way implies that one must have the freedom to make foolish decisions as well as wise ones, and these foolish decisions or mere lethargy may well lead to individual disaster. That is the price of freedom. The desire for security, on the other hand, is the desire to be protected from these misfortunes; therefore, clearly a basic problem is posed of how to accomplish that result without impairing the freedom itself. This conflict is expressed in the commonplace observation that the highest degree of security is to be found in jail, or by the less extreme observation that in a society dominated by status there would be at the same time a low degree of opportunity and a high degree of security. Moreover, the very hope of raising average living standards depends upon industrial progress. But progress of any kind implies change and, to a considerable extent, unpredictable change. That being true, the ideals of progress and security are, at least in their extremes, incompatible.

We must, however, recognize that individuals have both of these desires: the desire for improvement and the desire for security; and, therefore, in a good society a compromise must be sought. The first line of attack upon the problem of security should be to establish certain "floors" or minima below which levels the incomes and economic well-being of people should not be allowed to decline despite vicissitudes or the people's own foolishness. The competitive ideal in its unadulterated form is surely too rigorous to commend itself to people of humanitarian impulses, and it is well that that should be true. For a society in which the weak would be allowed merely to fall by the wayside is shocking to our better natures, and, moreover, a

society which followed that policy to extreme limits could well lose the values of mutual aid which are necessary to the existence of a society itself. The danger of going to this extreme is as real as the opposite danger, foreseen by certain anthropologists, of concentrating attention upon the weak and unfit and directing our chief solicitude to their needs.

The problem of setting such minima and of still retaining the essentials of a competitive system is largely a practical one of determining how high those minima should be. The problem is illustrated by the minimum wage, and the answer would seem to be that a minimum wage should naturally be somewhat above the wage which might be paid in some "fringe" instances in the absence of a minimum wage, but at the same time it should not be high enough to constitute the average wage or even to approach it closely. If we go so far that the minimum wage becomes the actual wage of a large part of the population, then we have government wage fixing, and we will have lost the conditions and the urge for that mobility of labor which is necessary to lead people to the occupations and the places where their services can most effectively be employed.

There is always a real danger of going beyond this limit partly because any success attained by such means in abolishing abuses at such extremes as are represented by sweatshop industry or child labor is likely to encourage us to use the same principle at higher levels. Another reason is that many people have a stake in the very immobility of labor which would be encouraged by the establishment of high legal minima. For example, the textile workers in New England, where the industry has been well established, would find it to their interest to insist upon such high minimum wages in the South as would, in view of the lower productivity of that area, make it unprofitable for the southern textile industry to develop. It seems quite evident that the real economic interest of the workers of the South could be impaired by such an extreme use of the minimum wage. A certain political representative speaking to the industrial workers of Detroit was quite frank in arguing that the workers of that city who were enjoying relatively high industrial wages should in their own interest insist that other parts of the country

which might aspire to become centers of automotive industries be required to pay a similarly high wage. An extreme form of this argument has appeared in the international sphere, where some American reformers have argued for an international minimum wage. Such an international standard, if it could be imagined, would be a most effective protection to American workers against foreign competition and a deterrent to the industrializing of backward countries. But for many countries such industrialization provides the only sound basis for higher wages. Nevertheless, the concept of minima, when kept within reasonable bounds, to deal with marginal and subnormal conditions deserves a place in the framework of a free and, at the same time, a humane society.

The problem of security has been aggravated by thinking of it in terms of occupational groups. It would be clarified if we were to search for security for individuals as citizens rather than for individuals in their occupational classification. For example, as to the problem facing many unfortunate people in the South, we should deal with them, wherever necessary, as poor people, not as poor cotton growers. To envisage the problem in the latter way leads to policies of restricting production, thereby creating artificial scarcities of cotton and raising the price of it. Such a solution is bad, fundamentally because the remedy for poverty is never to be found in scarcity but must always be sought in abundance. Moreover, it is bad because the cost of such a program is unfairly distributed to those who consume cotton goods. There would seem to be no special merit in requiring the industrial worker of the North to aid the sharecropper of the South in proportion to the number of cotton shirts the industrial worker must buy for his children. The burden of such aid should fall either upon individuals as they are prompted by generous contributions or by whatever principle the community agrees upon as the basis for taxation.

The obstacles in the way of the extension of social security programs dealing with people as citizens and not as members of particular occupational groups are two: first, the limitation which any tax places upon the freedom of the individual to spend his money as he sees fit. As to this, we have recognized

that there can and must be reasonable compromise. Second, the limitation set by the productive power of the society itself. Such a program of social security as would appeal to Americans as being worth while would cost so much that only a very productive society could possibly support it. But this obstacle, too, can be overcome. To overcome it requires only that productivity be kept high and particularly that the taxes which are required to support the security program should not themselves, because of their amount or their form, unduly reduce the incentives to production upon which that productivity rests.

The two lines of attack upon the problem of insecurity so far suggested are, first, to aim at such a high level of productive employment and such a degree of mobility of labor as will enable individuals who voluntarily or involuntarily leave one job to find another; and second, to establish by unemployment, sickness, and old-age insurance, and similar devices certain minima below which the rigors of competition will not depress any individuals. These two ways of meeting the problem of insecurity are consistent enough with the ideals of freedom of choice and opportunity, which, in turn, are essential elements of a liberal system.

But after everything that is feasible has been done along these lines, there still remains the fact that for many workers dislodgment from their existing position is a serious matter. The seriousness of this eventuality is in part created by the fact that, despite all we can do, the mobility of labor will be far from perfect. This is true because it costs money to move from one place to another, the worker can never have perfect knowledge of other job opportunities, and employers can never have perfect knowledge of available workers. Also, shifting employment frequently requires retraining, which may involve considerable loss to those workers who have become well established. Mobility of this latter kind may be fairly high for unskilled workers, as was shown during World War II when workers from some backward rural areas came in busloads to Detroit. But for workers to shift from locomotive operation to truck driving is a slow and painful process. Moreover, this mobility is impaired by the fact that finding a new job may require changing one's

place of residence and disrupting an established position in the community. As a result of these practical considerations, the two suggested approaches are not enough. There is still a widespread desire for security in the particular job, that is, a degree of security of tenure, and we should inquire if something can reasonably be done to meet that desire.

There is no perfect solution which will reconcile the ideals of freedom, opportunity, and maximum effectiveness of work, on the one side, with security in this sense, on the other. To say that, however, does not dispose of the problem, and, as a practical matter, a compromise must be sought under which advancement made toward the one ideal will frankly be made at the expense of the other. Many efforts are being made by groups within our society to enhance security of tenure. For example, labor unions demand and obtain preference in employment for their own members, and they have secured various seniority devices under which senior employees will be the last to be discharged and the first to be rehired. Such schemes run into the objection from the general social point of view that precisely to the degree that some individuals obtain security in these ways, others are deprived of it. The schemes are always, in one way or another and to a greater or less degree, arrangements for the protection of those who are "in" as against those who would like to "get in." Nor is this practice confined to labor unions. A group of retailers who succeed in establishing price controls, such as resale price maintenance, may reduce the retail mortality rate and thus enhance their own security, but at the expense of others who would like to compete for a position in the retail community by offering lower retail prices. This general line of attack upon the problem, therefore, under which organized groups seek their own security is no solution at all from the point of view of the whole community. The danger of leaving such programs to private and quasi-private groups, in which the established members of an occupation exert great influence and the potential members are rarely heard from, is apparent.

There are, however, some promising trends in policies affecting job tenure and security. In the first place, some individuals

may deliberately choose to accept somewhat lower incomes and reduced opportunities for advancement for the sake of enhanced job security. In so far as that decision is made deliberately and in full knowledge of the costs, it is less objectionable than the group devices which have been mentioned. In the second place, the very conditions of modern industry are impressing upon employers that a high rate of labor turnover is objectionable and costly, and, therefore, efforts are being made by these enterprises to retain workers by means of relocating them within the organization, retraining, and otherwise reducing the number of separations without an impairment of efficiency or the imposition of any arbitrary rules. Moreover, there is a growing recognition that fear of discharge and the consequent loss of peace of mind may, beyond some certain point, impair effectiveness. To the extent that this is true, some degree of assurance may be given and result in an actual increase in effectiveness. Then, too, there is evident among many more thoughtful business leaders a growing sense of ethical obligations to workers and an appreciation of the intangible values of morale which have led these leaders to seek practical ways of meeting this problem.

These attempted solutions, it is true, do not entirely avoid the objections mentioned before; in either case the established workers are given a preferred position at the expense of would-be workers. It is probable, however, that the best practical hope of progress lies along this line, for in these privately determined practices, arbitrary and rigid rules are avoided and the degrees of security can be adjusted to the practical possibilities in particular situations. Also, in so far as these rules or arrangements are generally known—for example, when they are embodied in statements of management policy or in collective agreements—there is opportunity for the public to weigh their merits and demerits from the point of view of the public or consumer interest. For these reasons private regulation of this conflict of interests is better than any rules recognizing property rights in jobs that might be imposed by the government. In the years to come, it may be that the conditions of industry will so develop and the ethical views of the community become so crystallized as to justify state interference in this troublesome

question. But to envisage that state of affairs requires that we foresee a diminution of the dynamic features of our economy, which at present is not in sight and which, in the interest of rising living standards, should not be encouraged.

A fifth line of reform within the framework of liberalism is an extension of education. The point was emphasized before that there must be equality of opportunity for individuals to make the best use of the abilities with which they may be endowed. Until very recent years, and then only in certain favored countries, the kind and amount of education available to men was determined by their station in society, by the economic resources of their parents, or by the special favors of the church or politically powerful individuals. By the existence of such limitations upon the opportunities for education, certain families and classes in the community could perpetuate their favored positions in the government and the professions. Of the various positive steps which can be taken to bring us closer to the ideals of liberalism, extension of educational opportunities would probably stand first. We in the United States can take satisfaction in the fact that higher education is more broadly available here than at any other place or time in the history of the world. Incidentally that fact, in the opinion of some foreign observers, goes farther to explain the high degree of productivity of this country than any other one consideration. The commendable record of our country should not, however, be a source of complacency, but rather it should point the way along which further improvement lies.

The ideal should be that no individual should be precluded by economic or arbitrary limits from attaining such a degree of education as he can profitably use. The details of such a program are being seriously considered by educators today. There is no need here to go into them, and there will surely be difficult problems to meet. For example, to what extent should public support of education be provided through federal, state, or local units of government? The liberal ideal, generally, is best served when community action is kept as close to the people as possible. That has been our national policy as to education, and it should be continued with exceptions made cautiously and only when

it is apparent that this salutary rule must for practical reasons give way to the more important requirement of general education as a basis for equality of opportunity. Also, there is the question, especially as to higher education, of how far we should expect young people to work for it. To say that they should be completely supported at community expense would, first, involve an extremely heavy burden upon the community and, second, mean the sacrificing of some of the educational values which many of us now recognize as inherent in the effort to provide for our own education. These and other practical and difficult questions must be faced; but the ideal remains, and it should have the active support of true liberals.

Sixth, as remarked before, the other great source of privilege is inherited wealth. In fact, this is probably not so important as inequality of educational opportunity, for, at least in a dynamic industrial and commercial environment, inherited wealth is generally dissipated in a generation or two if it is not supported by natural ability and education. But while nature has its own way of alleviating the problem, the state through its several powers can well aid in that process. One such power, although admittedly a clumsy one, is the power of taxation. The use of this power does not necessarily mean that wealth would pass to the state, for an alternative might be offered by which the owner could himself distribute wealth to foundations for advancement of education or other general welfare purposes or, indeed, to individuals, providing only that no substantial concentration was thus perpetuated.

There are other ways by which the objective can be sought. In general the maintenance of a dynamic and changing economy minimizes the power of inherited wealth and encourages the rise of new men. For example, the ownership of interurban electric transportation lines, passed on to heirs in the twenties, constituted no handicap to new enterprisers in the automotive field generally and in bus transportation in particular. Technological change is perhaps the best protection in the future as it has been in the past against any substantial limitation of opportunities created by inherited wealth. But this is not the place, even if it were possible, to propose the means for imple-

menting the general policy. We therefore merely point out that in the philosophy of liberalism we should minimize as much as possible, without doing undue violence to other rights, aspirations, and incentives, the effect of successes or failures of one generation upon the opportunities of people in the next generation.

Even this general proposition, it is true, encounters the objection that one of the opportunities prized by individuals is that they shall be able to provide for their families and heirs. It is believed, however, that reasonable compromise can be attained by permitting the transfer of wealth by inheritance to such an extent as to provide for reasonable, even for luxurious, living on the part of heirs without passing to them such large control over the natural resources and capital goods of the country as would enable them to restrict seriously the economic freedom of others.

Since the philosophy of liberalism includes individual opportunities as one of its essentials, it follows that, as an ideal, an individual in his lifetime should have an equal start with others, that he should be allowed to make the most of his opportunities, but that at the end of his life he should not be allowed to create special privileges in the next generation. (It should be recalled what was said earlier: that the ideal of *equal opportunity* implies *unequal rewards*.)

An analogy with competitive athletics may enlighten the issue. Some twenty years ago at a certain university, there was a very successful sprinter who gained great prestige. Now his son comes to the university and tries out for a place on the track team. He will have some advantages. In the first place, he has inherited a fine physique; in the second place, he has the inspiration of the family tradition; and in the third place, as a consequence of that fact, he has devoted himself to this sport from his early days. These natural advantages are comparable to those that some people have in the economic, political, or literary world. But we would think it unwarranted to give him a one-yard start in the trials because of his father's prowess. That would be bad for two reasons: it would violate our sense of equity, but also, if the members of the track team

were selected even in part on the basis of the fathers' ability, we would not get an effective team. In the economic world as in this case, we accept certain natural advantages, but we should strive to reduce the artificial ones. Also, in the one situation as in the other, the even start should be accompanied by as unequal positions at the finish line as the abilities, efforts, and even the "breaks" of the game permit.

The ideal, then, is to allow freedom and the natural play of competitive forces to operate throughout the span of a single life. To make that possible it is necessary that the state in its broader role of setting the stage for the play of these forces should, as far as possible and without undue violation of other principles, see to it that each lifetime is treated as a unit, with a minimum of favors or handicaps carrying over from the successes or failures of an earlier lifetime; that is, the state must take a hand at the two ends of a lifetime in order to insure freedom within that lifetime. If it be objected that this leaves out of account the corporation which goes on beyond a natural lifetime, the rejoinder is that we are here concerned with the equality of opportunity of individuals and that the corporation is not an individual. To gain the advantage of the perpetuation of successful corporations, it is not necessary that there should be a continuity of ownership or control of them. If these proposals be regarded as radical, as indeed they are, it should be borne in mind that liberalism is a radical doctrine. It is radical in the sense that to bring about its highest realization would require changes and in the more profound sense that it is a policy favorable to continual change, to shifts in fortunes, to the discarding of old methods of production, and to a continuous state of flux.

Other lines of reform, such as improved public health, support of basic research, some forms of applied research, and others will occur to anyone of humanitarian impulses and will suggest that a liberal program is not to be identified with callousness or a mere negative laissez-faire policy.

One of the most important general requirements to be borne in mind is that any positive program of reform should remain as far as possible within the framework of general law. The rule of law as distinguished from arbitrary actions of even well-inten-

tioned rulers is one of the most important foundation stones of a free society. Such a program must, therefore, keep to the practical minimum the arbitrary power of administrative officers or extralegal organizations of individuals seeking to advance their own group interests.

It is obvious that such a program will not be consistent with the view which many members of the extreme "right" so often express: that we must have less government interference with business. Just as the book of rules for football increases in size year by year as the game is refined and as the players invent and rulemakers discover various harmful practices, so the book of rules for our growing society must become more voluminous as time goes on, and so government must impinge more and more upon the affairs of its citizens. The liberal requirement is that these interferences shall, as in the game of football, be designed to improve the competition and not to serve as a substitute for it, and, in their net result, that they shall increase the area of individual freedom.

## THE FUTURE

A doctrine of liberalism and the kind of society that it envisages are not for all people. As Lord Acton in his *History of Freedom* wisely said: "Liberty is the delicate fruit of a mature civilization." Romantic philosophers of the eighteenth century and socialist writers of the nineteenth century conceived that man was born free and is now everywhere in chains. In this they were no doubt wrong. The history of freedom is not one of a fall from some earlier happy state. It is rather the history of early partial conceptions of the free society among the ancient Hebrews, Greeks, and Romans, followed by almost total eclipse in the Roman Empire and in the Dark Ages, then a new flowering in the Renaissance, and another great advance in the eighteenth and nineteenth centuries. Freedom requires a high degree of political genius and a continuity of civilization. It requires also a reasonable degree of peace and security from attack, for individual rights and freedom do not flourish in wartime. When the enemy is at the gates individual aspirations must be subordinated to the common defense.

As the fear of the enemy bolsters discipline and authority at the expense of freedom, so also does dire want. The growth of freedom and liberal ideas has come among people who were well above the subsistence level. The downtrodden may revolt in their despair, but more often than not such revolt leads only to new masters. The fact seems to be that with most people the desire for freedom follows, in the scale of priorities, the means of subsistence. Patrick Henry's "Give me liberty or give me death" was, if it is to be taken seriously, the mark of a rare soul. A distinguished Englishman a few years ago, when asked what would be the choice of his people if they became convinced that the only way to avoid widespread unemployment was to yield up a substantial part of their civil and economic liberties, replied that in his opinion they would, before such an unhappy choice, yield a substantial amount of their liberties. Insistence upon liberty is found among men who have banished abject fear.

On the other hand, and not inconsistently, widespread freedom and individualism are in modern society the best basis of productivity and economic well-being. The problem for backward countries, then, is that some degree of economic well-being is required before the institutions of freedom can develop and that a degree of freedom is required to attain a high level of production and well-being. We in America were fortunate in an unusual combination of factors: colonists coming from the middle classes, bringing with them the ideals of freedom, and moving into an environment which enabled them to avoid the grinding poverty that debases. Here were the bases for a free and prosperous society, and the growth of freedom and the advance of economic well-being supported one another.

These special conditions for freedom suggest a moral: there is no cause for pessimism or astonishment if people only recently removed from serfdom and from a mere subsistence economic level do not promptly see the merits of liberty and demand its blessings. A free form of society is not like a new model prefabricated house that you order from a mail-order catalogue. It is a structure that must be slowly and painfully built. The idea, for example, that Russia ought to "adopt" liberal ways

shows a naïve disregard of the economic roots that must nourish and the long cultural and political background that must precede the establishment of a free society. This is not to deny that good examples may help. It should not be necessary for a people today to tread step by step the long and hard road that our own people traveled through a thousand years of Anglo-Saxon political history, but, with all the advantages of human experience, it still remains true that freedom is not to be attained in a day.

And the history of freedom suggests a second moral: the gains that have been made in ages past by the Hebrews, Greeks, Romans, and others were reversed for long centuries at a time; and there is no assurance that this latest flowering of freedom will not, too, come to an end. The necessary conditions for it are most favorable in this country. We have the economic basis for it in the world's highest productivity and standard of living, and we have the necessary long tradition of free institutions. We now stand as the last great industrial country that avows the principles of our system of liberal democratic capitalism. If the torch of the liberal tradition, with all that it implies for human dignity and freedom, is extinguished here, it may be a long time before it is relighted anywhere.

# Index

# INDEX